Spotlight on…

Residential investment

Summary

■ Reduced accessibility to mortgage finance is likely to increase rental demand and act as the biggest spur to residential property investment since the 1988 Housing Act.

■ While income yields have been suppressed, total returns from residential property have been higher and less volatile than the majority of other investment assets over the medium and long term.

■ Future returns will continue to be underpinned by capital growth; fuelled by the increasing shortage of housing as rates of new build have been suppressed.

■ Future portfolio investment models are likely to incorporate increased elements of build-to-let, greater exposure to sectors such as student housing and shared ownership and to generate cash returns from a mix of income and capital receipts of different sorts.

Despite an aspiration to attract institutional investment to the residential sector for over 20 years since the introduction of the Assured Shorthold Tenancy, increased investment into the private rented sector has largely remained the preserve of small scale private investors. In comparison to the commercial property investment, it has therefore remained a cottage industry.

Three key drivers indicate that the role of residential property investment could change dramatically in the post credit crunch environment, when access to borrowing continues to be rationed. In summary these are as follows.

1. An increase in demand for private rented accommodation as first time buyers have difficulty in raising a sufficient deposit to access owner occupation within the housing market.

2. The continuation of housing scarcity fuelled by a shortage of the types of housing for which there is the greatest need in the most locations where they are most in demand.

3. A lack of funding to provide housing within the social rented and intermediate housing sectors, whether that be directly from public funds or from the development industry.

Historically, investment in the sector has been hampered by investors requiring residential property to conform to the commercial property investment model. To date the expansion of the private rented sector has been driven by small-scale, individual buy to let investors. The buy-to-let model is one for which there is currently precious little mortgage funding and which is therefore unlikely to continue to provide a major source of new rental supply.

Irrespective of the fact that total annual returns from residential property have been both more competitive and less volatile than other asset classes, and notwithstanding the fact that residential investment property offers better diversification of risk in relation to equities and gilts than commercial property, it has continued to be significantly under-invested in relation to commercial property.

In 2008, research that we conducted for the BPF and the GLA identified four main barriers to entry for institutional investors, namely:

1. The relatively low level of income return generated by residential investments in comparison with the disproportionately high amount of income lost due to management costs.

2. The uncertainty of the income stream given short lease terms and a higher perceived exposure to voids.

3. Small lot sizes and fragmentation of the market which have made it hard for institutions to achieve economies of scale.

4. The role of owner occupiers – who set prices by reference to the short term affordability in a market with an inherent lack of stock – rather than investors in setting prices.

While recent price falls have improved income yields, the yield shift in residential property has been much less dramatic than in commercial property. For example, although the yield on 'All commercial' property has moved out from 4.9% to 7.9%, according to IPD, gross yields for residential property in the UK have moved, on average, from 4.5% to 5.5%.

Portfolios offered for sale within the past 12 months, have generally been appraised at higher yields than these, typically in excess of 6%. Purchasers are looking to negotiate discounts of -20% to -30% from vacant possession value, under current trading conditions. In such circumstances, domestic demand has been supplemented by overseas interest, particularly from mainland Europe, as non-sterling buyers seek to exploit the relative weakness of the pound.

Only where opportunistic investors have been able to make bulk acquisitions of deeply discounted new build stock (usually direct from developers eager to maintain cashflow and keep lenders at bay) have yields of in excess of 8% been achieved on open market lettings.

Although many investors seek to replicate these returns by acquiring distressed stock, the reality is that low interest rates have limited the number of repossessions available to them. The flexibility with which lenders have dealt with their defaulters and their repossessed stock means that it has not been dumped on the market either in the number or at the discounts that might have been expected.

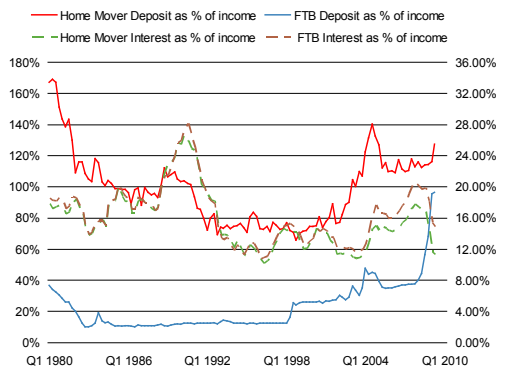
So, what form will future residential property investment take? How will investors be able to take advantage of a market where, over the past 30 years and three housing downturns, average UK capital values have doubled every 9.3 years?

The answer depends on what each investor needs.

Those investors with an existing commercial property portfolio might consider residential property because of its ability to diversify their risk exposure. For these investors, the fact that residential property values are not derived from investment yields will be more a strength than a weakness, and will help to protect their capital base in a downturn.

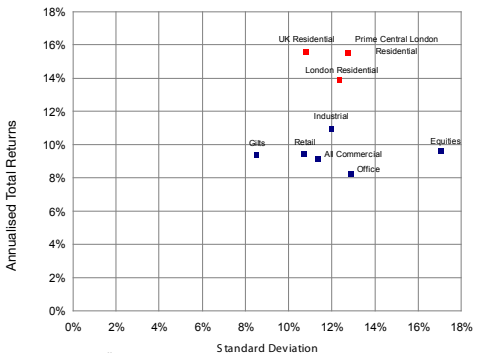
Low income yields, particularly in the context of costs of borrowing, mean that such investment is likely only to be undertaken by the cash-rich. For those investors, the prospects of medium capital growth will be appealing. The potential for such growth is underpinned by the current affordability of housing, which has been driven upwards by the combined effect of the housing downturn and low mortgage rates. The prospect of increasing

Graph 1. Deposit affordability heightened for first time buyers



Source: CML/Savills

Graph 2. Higher total returns/ lower volatility



Source: Savills/IPD

savills

A century of change

The housing market has seen four phases of change since the turn of the 20th century. In each of these phases, different types of tenure have been important. It is only in recent years we have entered the latest phase.

1. 1918 to 1953: Growing choice. A combination of building society mortgage finance for the masses and early public sector housing programmes gave occupiers a choice of tenure never seen before. At the turn of the century three in four occupiers rented privately, by the end of this period only two in four did.

2. 1953 to 1980: The decline of private renting. Rent controls in the post war era led to disposal of residential property by the investing institutions and the dramatic contraction of private renting from 50% to 10% of stock. The same period was an era of mass house building by local authorities, initially in response to post-war housing shortages and then slum clearance and redevelopment. The expansion of social housing from 18% of all tenures to over 30% went hand in hand with similar growth in owner occupation as the ownership of UK housing stock was transferred from landlords to former tenants.

3. 1980 to 2000: Right to buy. This era saw the accelerated growth of owner-occupation to a peak of over 70% but a reversal in the growth of social housing as ownership was again transferred from landlord to erstwhile tenant but this time it was public sector landlords who disinvested.

Source: Savills, CLG, Survey of English Housing

4. Post 2000: Private renting renaissance. Owner occupation peaked in the early noughties and is now in decline. The decline in public sector ownership may have bottomed out at 18% but private renting has grown from 10% to 14% of stock in just 8 years. This era is not over yet. We anticipate that private sector investment will grow this sector further – mainly at the expense of owner-occupation.

scarcity of housing, as new levels of development substantially undershoot projected increases in the number of new households, adds credibility to the capital growth-led investment proposition.

Those investors for whom a higher income yield is a more significant driver are likely to continue to seek ways to replicate the commercial property model. This ensures that debt-backed investment can be achieved at much higher loan to value ratios than apply to conventional residential investment.

The student housing sector has offered opportunities to this type of investor as it offers a model where capital values are a function of rental income streams. In the current market, net income yields of 6.25% for leased student stock or, as an alternative, leased housing association stock have provided both a stand alone investment opportunity and one that can enhance the income return of a larger portfolio of residential investments. However, these investments are not easy to secure and new players in the market may find them difficult to access.

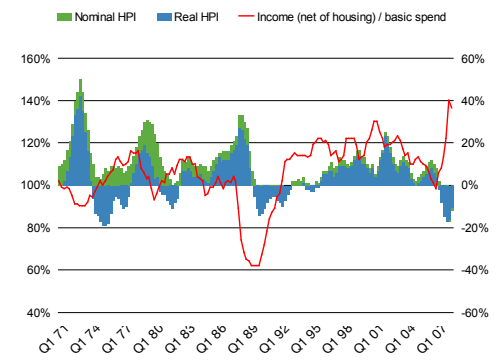
Build-to-let is the 'next big hope' for some in the industry. The combination of low land costs and market rents should create higher income returns, to compete with commercial property, at least initially.

Recently, build-to-let has been seen as means of kick-starting development and providing bespoke, corporately managed stock at sufficient scale to grow into institutional-sized portfolios. In particular the HCA is currently looking at stimulating the private rented sector and helping to create new funds, which would facilitate a build to let approach. There has already been the first of several announcements of forthcoming institutional investment in US style build and manage operations to deliver rented accommodation in high demand areas.

In order to establish a model which delivers:

- A portfolio of sufficient size to be attractive to institutions and achieve the economies of scale that produce cost savings which in turn improve the relationship between gross and net yields; and

Graph 3. Affordability set to fuel price growth



Source: Savills

savills

Table 1. Forecast for residential investment returns

	2009	2010	2011	2012	2013	5 yr av
Average UK House Price	185,300	179,500	181,300	197,700	217,400	
Average UK Rental Value Gross	10,800	10,900	11,400	12,200	12,700	
Average UK Rental Value Net	7,600	7,600	8,000	8,500	8,900	
Gross Yield	5.8%	6.1%	6.3%	6.2%	5.8%	6.04%
Net Yield	4.1%	4.2%	4.4%	4.3%	4.1%	4.23%
Capital Growth	-7.2%	-3.1%	1.0%	9.0%	10.0%	1.94%
Total Return	-3.1%	1.1%	5.4%	13.3%	14.1%	6.17%

Source: Savills

- A sufficiently high standard of overall product, in terms of the physical accommodation, ancillary services and management, to generate rental premiums;

The HCA has suggested that they may encourage investment in the sector by initially guaranteeing rents in order to achieve a minimum/competitive income yield of as much as 8% for as long as five years.

The ability to replicate such a return in absence of government intervention will be crucial as ultimately the property industry needs to take the central role in building the professionally managed investment vehicles in which the institutions can invest. Assuming that rental guarantees do not have widespread application, carefully designed tax incentives may be appropriate.

Unless a real rental premium becomes established for residential rental property, it remains difficult to see how the yield advantage can be maintained over time before owner-occupied values start to distort the figures again. This has led to the suggestion that a separate planning use class should be created to divorce the capital value of investment property from owner-occupied assets. The option has the disadvantage though of blocking the potential exit route to an investor of open-market, individual, property disposal. It also decreases the overall, long-term flexibility of stock tenure at a time when it may be more appropriate to increase the ability of occupiers to move between tenures. It may be that time-limited restrictions on owner-occupation may be appropriate, though perhaps not ideal, in such cases.

If the potentially complicating and distorting factor of a separate planning use class is to be avoided, it seems likely that a different type of investment vehicle needs to be created. Through the life of an investment, cash returns will need to be derived, not just from rents but also from capital receipts in much in the same way that is seen in local authority stock transfer funding.

This means an investment model which includes not just private sector rents but also intermediate and social rents, staircased shared-ownership and other capital receipts is needed. It will require an imaginative, and perhaps radical innovation of new investment vehicles to achieve this. ■

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