Briefing

Resolution Foundation

Building Homes for Generation Rent

Can institutional investment meet the challenge?

Vidhya Alakeson, Katie Blacklock, Sandra Halilovic, Tim Rothery and Nick Salisbury

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E: info@resolutionfoundation.org

T: 020 3372 2960

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About the Authors

Vidhya Alakeson is Deputy Chief Executive at the Resolution Foundation

Katie Blacklock is a Fellow at the Resolution Foundation

Sandra Hallilovic is an Associate at Social Finance

Tim Rothery is an Associate Director at Social Finance

Nick Salisbury is a Director at Social Finance

Executive Summary

There is an urgent need to increase the supply of housing in the UK to address the growing affordability problems faced by low to middle income families. We need to increase the supply of all types of housing in view of the scale of the challenge. But given that large numbers of low to middle income families are shut out of home ownership for the medium to long term and do not qualify for social housing, addressing supply must include a focus on market rent homes. Market rent is no substitute for an adequate supply of social and affordable housing, but it could play a greater and more positive role in addressing the UK's acute housing needs.

In doing so, we must also offer a better deal to 'generation rent' based on purpose-built properties, more professional management, more affordable and transparent rents and greater security of tenure. The UK's private rented sector remains characterised by individual landlords, older properties, short term tenancies and variable quality. Changing the offer is particularly important for families with children, who now make up a third of the 3.8 million households living in the private rented sector.

A purpose-built rented sector managed by professional landlords and financed by institutional investors such as pension funds and life companies offers the potential to deliver a greater supply of market rent properties alongside a better deal for tenants. Institutional investment underpins the build to rent sector in the US and in several other European countries but despite a number of attempts in the last decade to secure investor backing to kick start the sector in the UK, it has so far failed to take off.

A central question underpinning its slow development is the extent to which a better deal for tenants is compatible with investor expectations. And, if build to rent represents a viable proposition for investors, can it meet the affordability needs of low, modest and middle income families in different parts of the country or is it only a solution for higher income tenants in London?

The analysis presented in this report attempts to take the debate over build to rent to the next stage by using real data from actual or planned developments and examining where and how build to rent might work, what the improvements for tenants could be, what the returns for investors might look like and where the key challenges lie.

This analysis demonstrates that build to rent can deliver an affordable, more secure rental product for modest and middle income tenants in different parts of the country at the same time as delivering a competitive return for institutional investors at relatively low risk. From an investor perspective, the return from build to rent set out here offers a degree of inflation hedging, with rents expected to rise in line with CPI over the long run, and the build to rent asset class also offers significant opportunities for diversification within an overall investment portfolio.

Despite these clear opportunities, build to rent has been slow to take off because, while it does not require public subsidy or significant policy change, it does depend on effective partnerships between housing providers and investors to address historic concerns around scale and the risks associated with residential investment, as well as careful site selection and the efficient delivery of schemes. To date, these necessary ingredients have rarely come together.

The return profile of the build to rent portfolio

The national portfolio presented here comprises 16 sites built and managed by six housing partners with an overall development value of £140 million. The 778 units that make up the portfolio provide tenancies of three years for those who want to stay longer term.

The portfolio delivers a 3.9 per cent income return and a 6.5 per cent total investor return (IRR, assuming modest inflation of 2.5 per cent per annum).

This initial return can be significantly improved by making care choices about the nature and management of the portfolio rather than any policy or legislative change, including:

- Careful site selection - build to rent will not deliver competitive returns in all areas;

- An increase in average tenure from its current average of 19 months to 38 months as a consequence of providing greater security and a better offer for tenants.

- A 15 per cent reduction in land costs in line with the use of a 'PRS only' covenant;

- A 5 per cent reduction in build costs as the sector matures and gains efficiency in developing property specific to the private rented sector;

If optimised in this way, income returns improve from 3.9 to 4.7 per cent and the total investor return rises from 6.5 to 7.2 per cent over the same ten year period. Further improvements to returns could be made through the application of the £10 billion government debt guarantee for the private rented sector. On the basis of a 4.25 per cent interest rate (using similar existing guarantees as a benchmark) and 50 per cent gearing, the total return to equity investors from the national portfolio rises from 6.5 per cent to 8.3 per cent, on a comparable basis

However, even with as well as careful site selection and the efficient delivery of schemes, build to rent is unlikely to work for low income tenants without significant public subsidy, such as a reduction in the price of land. Therefore, the development of build to rent needs to sit alongside efforts to increase the supply of affordable and social rent homes rather than acting as a substitute for them. Local strategic priorities must be the deciding factor as to the mix of housing types required in each area.

While our analysis shows that developing a viable build to rent product does not require policy or legislative change, further action by national and local government and other stakeholders would encourage greater activity. Central to this is the use of public land to stimulate the market. The Homes and Communities Agency, Greater London Authority and local authorities should designate a proportion of their public land for private rented sector development only. Furthermore, local authorities need to recognise that build to rent provides lower returns than build for sale and adjust their affordable housing and other planning requirements accordingly. If not, build to rent will continue to lose out to the higher return build for sale market.

Alongside other initiatives to stimulate house building, the development of build to rent could be an important new source of housing supply in the UK and a way of providing long term modest and middle income tenants with more affordable, more secure and more professionally managed homes.

Introduction

It is well documented that the UK has a housing supply shortage which is the result of the year on year failure to build enough homes to keep up with demographic change. This has kept house prices historically high despite the recession and downturn.[1] In 2012, the median house price in England was seven times the median wage compared to only four times the median wage in 1997, with median prices in inner London boroughs averaging 10 times the median wage.[2]

Although very low interest rates have kept home ownership within reach of some who would otherwise have been priced out, high prices have pushed it beyond the reach of many low to middle income households. Even the high loan to value mortgages on offer under the government's Help to Buy scheme leave properties in nearly half of all local authorities out of reach of a low income family on £22,000 a year unless they spend more than 35 per cent of their net income - a commonly used measure of affordability - on monthly mortgage payments.[3]

Many of those who are priced out of ownership will be long term renters. The proportion of households living in the private rented sector has increased from 10 per cent of all households in 2001 to 17 per cent in 2010.[4] This creates a need to focus specifically on increasing the supply of market rent property. In particular, with a third of these 3.8 million households being families with children, there is a specific demand for properties to meet their requirements which are often substantially different to those of the younger, more mobile tenants who have historically comprised the private rented sector.[5]

The UK rental market is currently characterised by small buy-to-let landlords who own one or two properties each. Outside of social housing, rental property is not purpose-built but is built for sale and sold to buy-to-let investors. Only 10 per cent of the market is made up of large, professional landlords with significant portfolios (defined as more than 10 properties).[6] This means that the current market tends to be variable in quality and provide only one core product: assured short-hold tenancies of six months to a year.

In the context of the changing profile of tenants and the growth of long term renting, there have been several attempts in the last decade to kick start a purpose-built, professionally managed build to rent sector similar to that in the US and in many parts of Europe. In other countries, the growth of this sector has been part funded by institutional investors such as pension funds and life companies that have been drawn into the sector by government action in the form of incentives or requirements. For example, in Switzerland where institutional landlords own nearly a quarter of PRS units, institutions are required by law to invest in real estate and residential properties form an important part of that allocation.[7]

In the UK, institutional investment in residential property has tended to focus on social housing, although more recently there have been several London-based private rented sector deals announced. In January this year, M&G Investments announced its purchase of 401 market rent homes in the Stratford Halo development on the edge of the Olympic Park from Genesis Housing Association in a 35-year deal worth £125 million.[8] In August 2013, Essential Living, funded by the American investor, M3 Capital Partners,

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[1] Doherty, A. (2013) *The Case for Investing in Affordable Housing*, London: Schroders.
[2] DCLG, Ratio of median house price to median earnings by district, from 1997, available at http://data.gov.uk/dataset/ratio-of-median-house-price-to-median-earnings/resource/3a73de15-73df-487c-9144-111f09f5912f
[3] Resolution Foundation analysis of Hometrack data 2012-13
[4] DCLG English housing survey homes report 2010
[5] De Santos, R. (2012) A Better Deal: Towards more stable private renting, London: Shelter
[6] DCLG (2010) Private Landlord Survey, London: TSO.
[7] Scanlon, K. and Kochan, B. eds. (2011) Towards a sustainable private rented sector. The lessons from other countries, London: LSE.
[8] http://www.insidehousing.co.uk/finance/investor-ploughs-%C2%A3125m-into-groundbreaking-prs-deal/6525252.article

announced the first institutionally funded market rent development project in London, in Elephant and Castle.[9]

With the intention of stimulating greater market activity, in 2011 the government commissioned an independent review led by Sir Adrian Montague to investigate the barriers to institutional investment in build to rent in the UK. The government responded to the review's recommendations by putting in place a build to rent equity fund, committing to a £10 billion debt guarantee and establishing a task force to stimulate the development of this new asset class. Short-listed projects from the first round of the build to rent fund are currently going through due diligence, with a second round opening in the autumn.[10]

A central question underpinning the slow development of build to rent in the UK is the extent to which the returns from these purpose-built, market rent schemes can meet investor expectations? What is the risk and return profile that market rent developments can deliver in different parts of the country and how does that match the expectations of different kinds of investors? How can these risks be intelligently shared between the different parties involved? If build to rent can deliver a viable investment proposition, can it also offer a better deal for tenants and which groups of tenants can it serve? Does build to rent represent a viable investment proposition outside of top quartile developments in London?

This report shows that a geographically diverse market rent portfolio can deliver a competitive investment proposition without assuming above inflation rental or capital growth if sites are carefully selected, development and management costs are optimised and the portfolio benefits from a reduction in the costs of debt through a robust government guarantee. None of these measures requires policy change but simply the optimisation of existing opportunities. In meeting investor expectations, the portfolio can also offer modest and middle income families a more secure, professionally managed rental product at a reasonable rent in most parts of the country. However, build to rent is unlikely to work for low income tenants without significant support from government because the level of rent that would be affordable to these tenants cannot on its own support a viable investor return. We can, however, estimate the scale of support which would be necessary.

This report intends to advance the debate on the viability of build to rent and is based on the development of a detailed financial model. The modelling has been led by the independent think tank, the Resolution Foundation, and the not-for-profit financial intermediary, Social Finance, in partnership with six housing providers: Dolphin Square Foundation; Derwent Living; GreenSquare Group; Great Places: Home Group; and Plus Dane. Five of these housing organisations are Registered Provides and the sixth is a charitable housing provider. The financial model has been developed with the same level of robustness that would be expected from a commercial venture and is based on development and management costs and rents provided by each housing provider on actual or advanced pipeline developments. The returns have been scrutinised by a range of investors and the findings presented here reflect the input of a significant amount of investment expertise.

Section 1 of this report describes the build to rent portfolio that has been put together across the six housing providers, setting out its scale, location, development costs and the deal it offers to tenants. Section 2 looks at the returns from the portfolio, focusing first on the income that can be expected from the rent once management and other costs have been deducted and then considering the combined income and capital return that investors can expect. The returns presented in this section are based on a set of assumptions about inflation, capital structure and taxation that have been informed by investor feedback gathered as part of the project. Section 3 looks at a range of strategies for improving returns.

[9] http://www.london.gov.uk/media/mayor-press-releases/2013/07/mayor-announces-groundbreaking-housing-deal-for-elephant-and

[10] http://www.homesandcommunities.co.uk/ourwork/private-rented-sector

Section 4 discusses the potential impact of the government guarantee and Section 5 looks at approaches to improving affordability for tenants. Finally, Section 6 presents a set of conclusions and recommendations for national and local government, housing providers and investors.

Section 1: A national build to rent portfolio

This project set out to develop a financial model for build to rent that would demonstrate what returns investors could reasonably expect from this emerging asset class. As part of this overarching aim, the particular approach to build to rent that we have adopted and is presented here has been shaped by the requirements of the different stakeholders involved: tenants, housing providers and investors.

From a tenant perspective, our aim was to target those tenants who are unlikely to be eligible for affordable housing but for whom the private rented sector currently does not provide a compelling offer. We therefore sought to create a portfolio that was predominantly market rent but not one targeted at the top quartile of the rental market. We were looking to test the investment viability of a rental product that would be affordable to families on low to middle incomes. We also wanted to improve on the standard product currently available within the private rented sector by offering a purpose-built, professionally managed product that would provide greater security of tenure.

From an investor perspective, we set out to create a portfolio that would provide adequate scale– around £150 million of assets as a starting point.[11] We also wanted to test the extent to which there were viable investment opportunities nationwide not just in London and the South East and, therefore, sought to assemble a national portfolio.

While not all of the housing providers we worked with were insistent on taking the rental units off-balance sheet once they were built and let, the majority were looking for an opportunity to recycle their capital by selling the units on to an investor. We, therefore, adopted an approach that did not involve the housing providers retaining significant long term ownership or providing on-going rental or void guarantees. However, they do retain the Operations & Maintenance (O&M) contract for the units that they each build on a fixed price basis. Developments are typically in areas where they have significant existing operations.

Defining low to middle income tenants

This report considers affordability from the perspective of three different levels of net income after taxes and benefits:

- A low income family – a couple with one child at the 25th percentile of the working-age household income distribution with a net income of £18,583
- A modest income family – a couple with one child at the 35th percentile of the working-age household income distribution with a net income of £21,962
- A middle income family – a couple with one child at the 50th percentile of the working-age household income distribution with a net income of £27,584.

In all cases, we assume that a couple with one child lives in a two bedroom property.

Putting these objectives together, we assembled a theoretical build to rent portfolio made up of real development sites and input costs provided by the six housing providers. We assumed that each of the six housing providers would contribute units from developments in its own geographic area to a single national portfolio. The entire portfolio would be purchased by a single investor or investment fund once the units were fully built, tenanted and the rental income stabilised. By selling the units on, the

[11] Alakeson, V. (2012) Making Institutional Investment in the Private Rented Sector Work, London: The Resolution Foundation.

developments would not tie up the balance sheets of the housing providers over the long term. The rest of this section describes the portfolio and its offer to tenants.

The portfolio

Pooling developments across the six housing providers results in a geographically diverse portfolio of 16 developments and 778 units. The portfolio comprises market rent developments, except for two London-based developments which are offered at a sub-market rent (75 per cent and 50 per cent of market rent respectively) as part of the terms of a Section 106 agreement.

Figure 1 below shows where in the country the 16 developments are located and Figure 2 shows the distribution of unit types – flats or houses by number of bedrooms - within the portfolio. Of the total 778 units, 482 (62 per cent) are houses and 296 (38 per cent) are flats. Two and three bedroom units are most common, comprising 82 per cent of the portfolio. Compared to existing market rent stock, the portfolio has a higher percentage of two and three bedroom properties and a greater proportion of houses rather than flats. This makes it well suited to low to middle income families with children looking for larger properties and houses with gardens rather than flats.

Figure 1: Map of 16 developments in build to rent portfolio

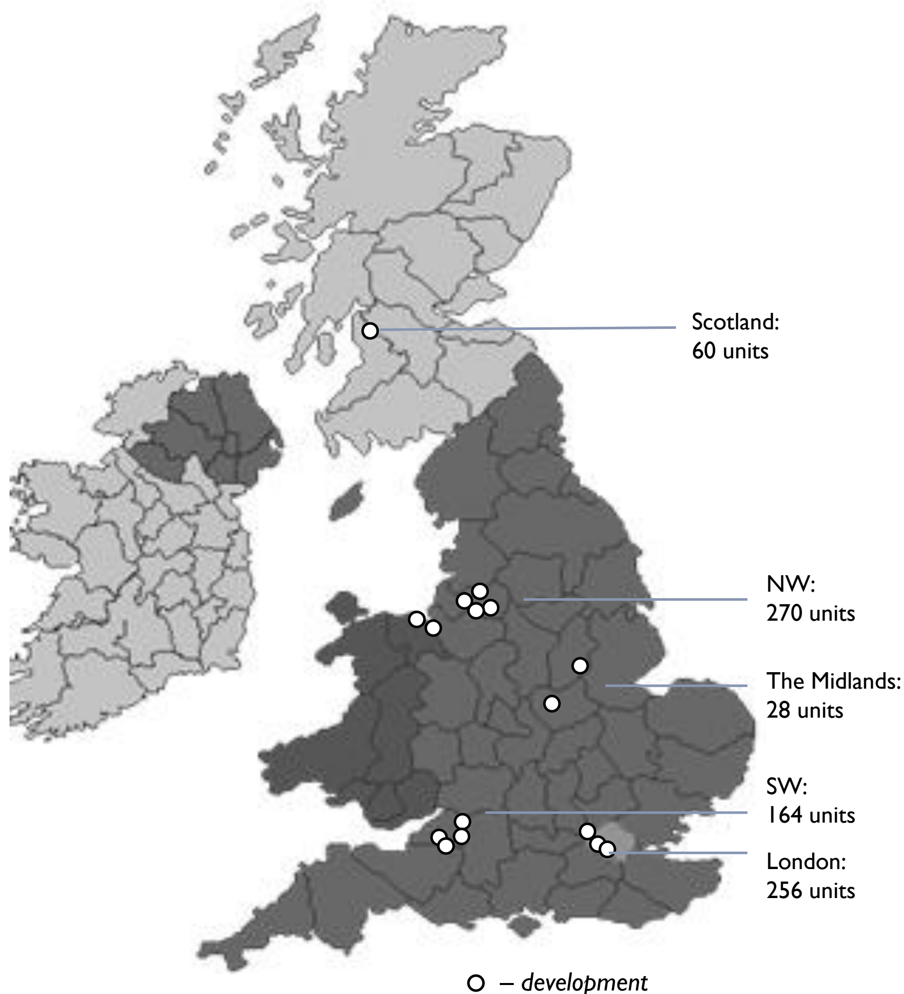
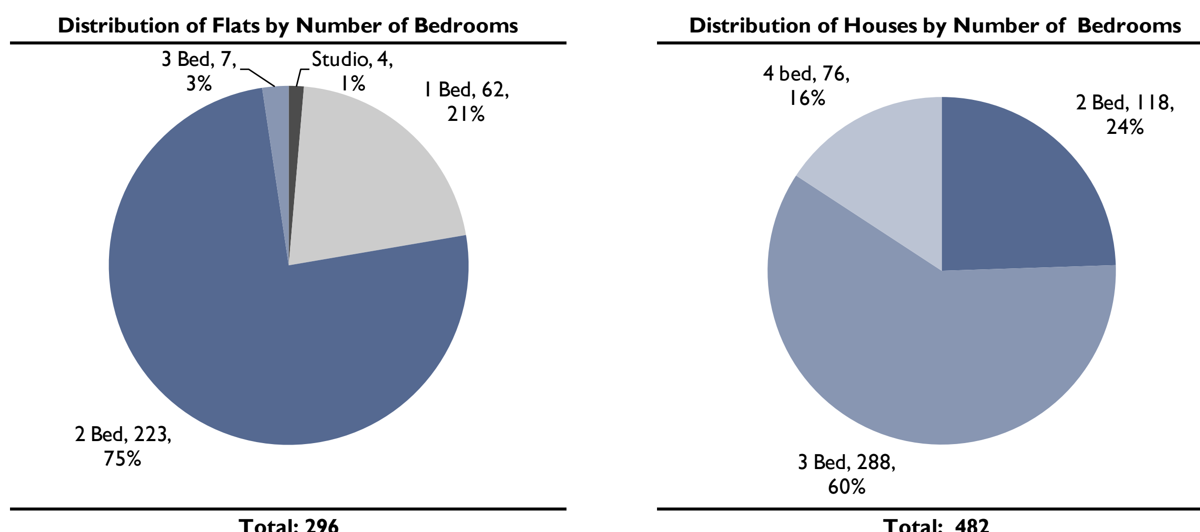


Figure 2: Distribution of unit types within the portfolio



The combined portfolio of 778 units has a total development value of £140 million or £180,000 per unit. Given that five of the six housing providers we worked with are Registered Providers (RPs), we have been able to keep development costs competitive because RPs can capitalise on relatively low borrowing costs for the development phase. Table 1 provides a breakdown of the development costs of the portfolio by unit type and region.

Table 1: Characteristics of the 16 developments by unit type and region

Development Characteristics - Full 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%
Outer London	152	20%
South West	164	21%
Midlands	28	4%
Northwest	270	35%
Scotland	60	8%
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)**

The total development cost includes any Section 106 and Community Infrastructure Levy costs related to infrastructure that would be required by the local authority in question. These amount to 16 per cent of the administrative and regulatory costs shown in Table 1 and 1.3 per cent of total development costs. The development cost also includes a 5 per cent developer margin that is payable to the housing providers. This is much lower than the 20 per cent developer margin that private sector developers would expect if they were taking full risk on the development and reflects the fact that there is a committed exit to investors. The margin, therefore, only covers the risk that the housing partners bear for the stabilisation period. In the majority of cases, this risk was felt to be relatively small because of the high demand for quality, affordable market rent stock among tenants. However, the extent to which housing providers can accept a 5 per cent developer margin would have to be judged on a case-by–case basis.

It is worth noting that a change to the regulation of Registered Providers to clearly separate social housing activity from market-based activity, whether market rent or for sale, would increase the development costs presented here. RPs would no longer be able to secure the preferential borrowing rates that they currently enjoy for market based activity because they would no longer be able to draw on their wider corporate covenant. They would also have to add in a more significant developer margin than the current 5 per cent because their private rented operations would be smaller in scale and could, therefore, not absorb the level of risk they can currently manage across the wider organisation. By increasing development costs, both elements would ultimately dampen returns.

Tax

Liability for several taxes arises at the point of sale of a property asset. For the purposes of this model, we have assumed that Stamp Duty Land Tax (SDLT) will be levied on a multiple dwellings basis on each of the 16 developments. Based on the average unit price per development, 14 of 16 developments incur an SDLT rate of 1 per cent and two incur a 3 per cent rate.

Corporation Tax and Capital Gains Tax are also charged on the sale of the assets but for the purposes of this model, we assume that neither would be paid. As the majority of RPs and housing providers have charitable status they and their subsidiaries will not be liable for corporation or capital gains tax if the profits are used by the charity to further its charitable objective.

While the charge of capital gains or corporation tax at the point of sale to the investment vehicle does not impact returns for the investor, it clearly has a significant bearing on returns to the housing providers. It will therefore be important that the right structures are in place internally before housing providers embark on developments of this kind.

We have assumed that VAT will not be payable by the investment vehicle because as the first sale of a new build residential property, the transaction will be zero rated for VAT. The purchaser will be able to recover VAT on purchase costs.

Affordability

The weekly rents for two bedroom properties in each development are shown in Table 2 below. Where developments include flats and houses or different rent levels within the development, these are shown separately. The rents span a broad range from £115 a week to £500 a week for two bedroom properties in 2014. Therefore, affordability will vary across the portfolio.

Table 2: Weekly rents for the two bedroom properties across the 16 developments

Development*	Weekly Rent (£)
Midlands 1 (house)	115
North West 3 (house)	121
North West 4 (house)	121
South West 1 (house)	126
Scotland 1 (flat)	127
Midlands 2 (house)	127
South West 4 (house)	131
South West 3 (flat)	132
South West 3 (house)	144
North West 2 (house)	144
South West2 (house)	149
North West 6 (flat)	153
North West 5 (flat)	230
Outer London 1 (flat)	254
Inner London 2 (flat)	267
Outer London 1 (house)	300
Inner London 1 (flat)	360
Inner London 1 (flat)**	500

*Development NW1 is not shown in Table 2 because it only comprises 3 bedroom properties.

**£500 weekly rent for Inner London 1 provides an internal cross subsidy to make other flats in Inner London 1 more affordable.

Given that our target market for this portfolio is low to middle income families, we assess the affordability of the developments in the portfolio from the perspective of a couple with one child at three different levels of net income after taxes and benefits: £18,583 representing a low income family at the 25th percentile of the working-age household income distribution; £21,962 representing a modest income family at the 35th percentile; and £27,584 representing a middle income family at the median. Figures 3, 4 and 5 show the percentage of net income each family would pay to rent a two-bedroom property. Where developments include flats and houses, they are shown separately as the rents differ.

Figure 3: Affordability for a low income family at the 25th percentile of the income distribution (UK)

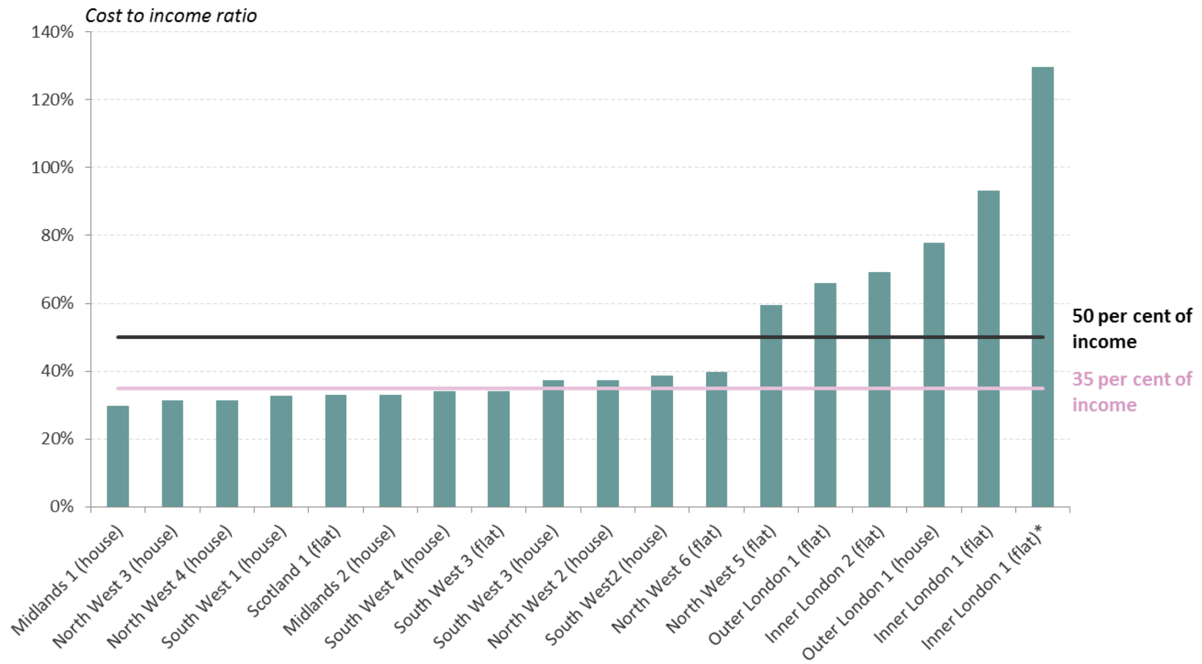


Figure 4: Affordability for a modest income family at the 35th percentile of the income distribution (UK)

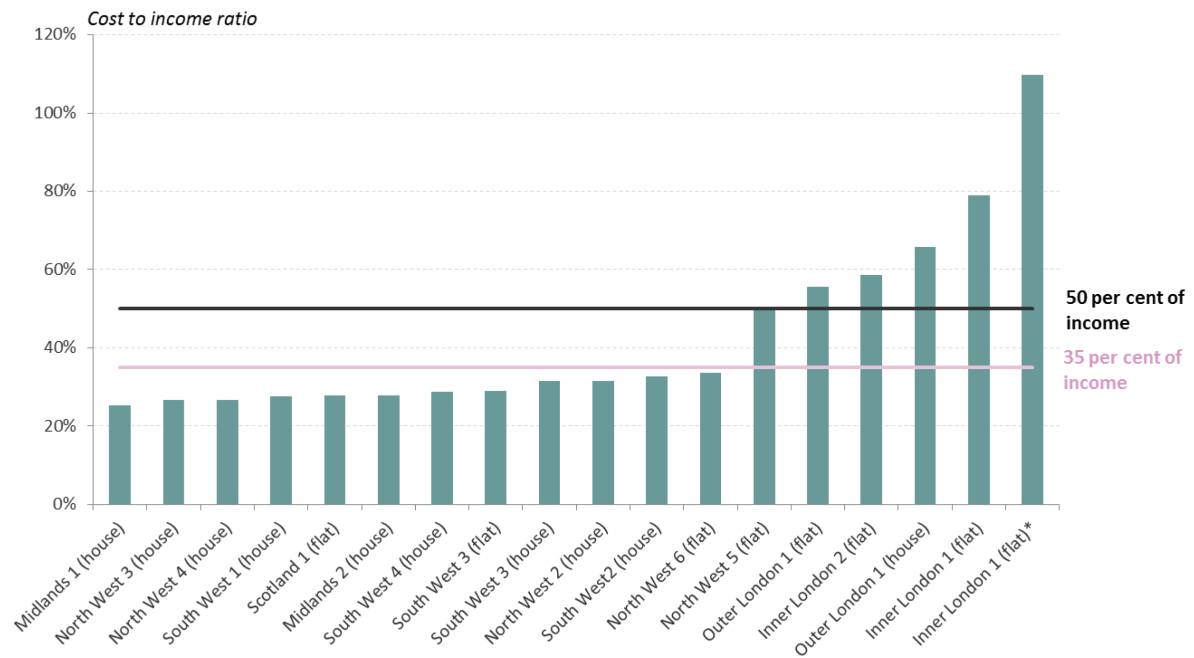
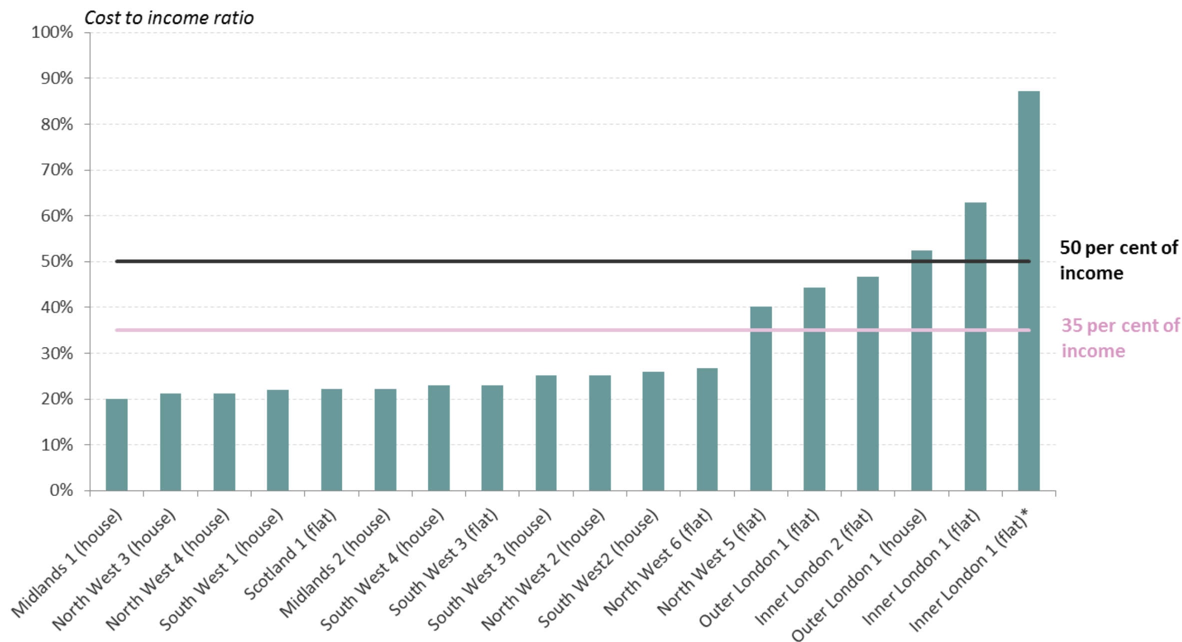


Figure 5: Affordability for a middle income family at the median of the income distribution (UK)

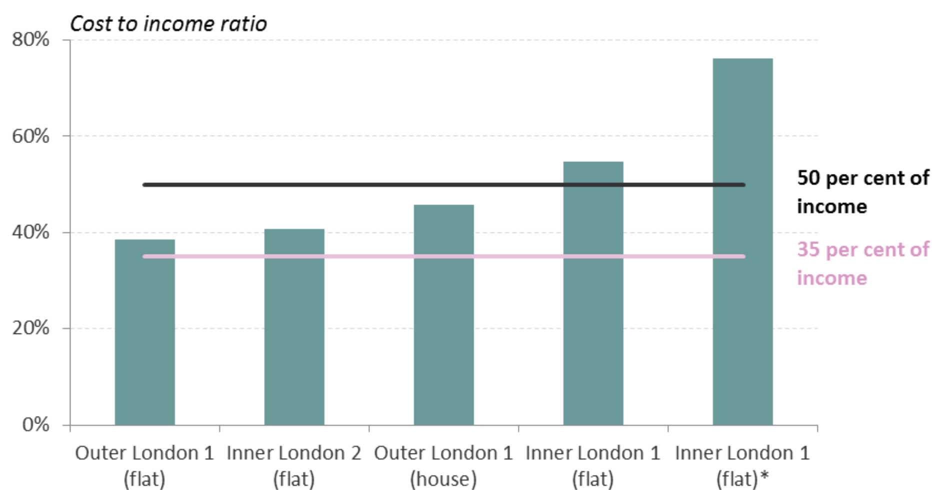


It is difficult to set an absolute threshold for the percentage of net income that a family should spend on rent. To some extent it is a personal choice. Some families may prefer to pay a higher rent to live close to a good school or to reduce transport costs, while others would choose to have more disposable income after housing costs. However, particularly for lower income families, high rents are a problem because they can make it difficult for families to meet other basic costs of living such as food, fuel and transport.

Looking across the three charts, as family income rises, the number of developments within the portfolio in which the rent level is comfortable – below 35 per cent of net income – increases, from just under half for the low income family to two thirds for the modest and middle income families. For the middle income family on £27,594, only three out of 18 developments require the family to spend more than half of its income on rent.

Within the portfolio, the developments where the rents are most challenging for low to middle income families are based in London where high land prices and population growth keep rents high, even with the benefit of the Section 106 discounts which two of the London developments enjoy. To get a better perspective on the affordability of the London developments within the portfolio, we look at them again in Figure 6 in the context of median income in London rather than nationally. Higher rents in London are somewhat balanced out by higher wages and higher levels of Housing Benefit. In London, a couple with one child at the median has a net income after taxes and benefits of £31,661 compared to £27,594 nationally. As Figure 6 shows, in a London context, two of the developments continue to challenge a median income family, with one remaining out of reach without significant sacrifices elsewhere.

Figure 6: Affordability for a family at the median of the income distribution (London)



From the analysis above, we can conclude that the rent levels within the portfolio are largely comfortable for a middle income family and while a stretch in some cases, are not entirely out of reach for a modest income family at the 35th percentile. However, the analysis also highlights the fact that market rents will be challenging for low income families. On a low income, spending more than half of that income on rent leaves families struggling to keep up with other costs. While we have looked at a couple with one child living in a two bedroom property, the same pattern of affordability holds true for other family types requiring different sized properties, for example a larger families living in a three bedroom property or a couple without children living in a one bedroom property.

We will look at improving affordability in Section 4 but it is unlikely that build to rent as a market product delivered without government guarantee or some other form of subsidy can meet the needs of low income families.

Tenancy length

As the private rented sector becomes a long-term tenure rather than an interim solution before buying a house, tenancy security has become ever more important. While the flexibility of the private rented sector suits some, a third of households renting privately are families with children who require stability and security of tenure.[12] Despite the fact that longer tenancies can be offered within the current legal framework of Assured Shorthold Tenancies (ASTs), buy to let mortgage lenders have traditionally been reluctant for landlords to offer more than a six to 12 month tenancy. The sense of insecurity this causes tenants is compounded by a lack of visibility on rent increases, with private landlords tending to adjust rents on a sporadic and "lumpy" basis.

In markets such as Germany, Switzerland and France where the private rented sector makes up a higher proportion of the housing stock than in the UK, security of tenure and rent transparency are far greater. Contract length is indefinite in both Germany and Switzerland and between one to three years in France. In all of these countries, tenants can be evicted for non-payment of rent, criminal damage or if the landlord wants the property for personal use, but otherwise the tenancy is secure with visibility on rents that are linked to inflation or kept in line with market rates. Renter flexibility is also protected under these

[12] De Santos, R. (2012) A Better Deal: Towards more stable private renting, London: Shelter

regimes, with tenants able to end contracts with average notice periods of between one and three months.[13]

The portfolio presented in this paper assumes that units will be offered on the basis of longer tenancies of three to five years in line with the latest market developments. Longer tenancies would continue to be achieved through an AST, but utilising a longer fixed term than the standard six or twelve months. Tenants would continue to have the ability to break the contract by giving three months' notice, subject to a minimum letting period of six months. Dolphin Square Foundation and Genesis Housing Association are offering three and five year tenancies respectively to private tenants in London and the Nationwide Building Society announced in June of this year that it would support buy to let landlords to offer longer tenancies.[14]

Annual rent increases will track CPI and are assumed to be on average 2.5 per cent annually. Keeping rents in line with CPI gives tenants greater visibility over future rent increases than in the current market. Tenants are able to budget based on predictable annual increases and investors can expect a predictable inflation linked cash flow. Assuming rents rise in line with CPI can also protect affordability for tenants as long as wage adjustments do not lag CPI as is currently the case.[15]

Having outlined the portfolio, its development costs and associated rental income, the next section addresses investor returns. It first looks at the expected income yield based on the overall rent from the portfolio and the costs that have been assumed for management, voids and bad debts. It then goes on to look at the combined income and capital return based on inflation, tax and gearing assumptions and discusses how these compare with investor expectations.

[13] Scanlon, K. and Kochan, B. eds. (2011) Towards a sustainable private rented sector. The lessons from other countries, London: LSE.

[14] Nationwide gives landlords the option to offer longer term tenancies http://www.nationwide.co.uk/mediacentre/pressreleases/viewarticle.htm?id=2194

[15] Whittaker, M. and Hurrell, A. (2013) *Low Pay Britain 2013*, London: The Resolution Foundation

Section 2: Investor returns

If build to rent is to work for institutional investors it will need to do so by providing a robust, stable income flow rather than solely relying on short term capital appreciation. However, investors will judge the investment proposition offered by build to rent on the basis of both types of return: the income return which is the rent from the portfolio expressed as a percentage of the development cost; and the combined total investor return from income and the year on year increase in the underlying capital value of the portfolio expressed as an internal rate of return (IRR). Each type of return will be considered in turn, but we would emphasise the importance of the income return for two reasons. First, this is a long term rental portfolio, and is not based on the intention to sell the assets and realise the capital value. Second, we have significantly greater visibility in forecasting a steady state income return than in speculating on future short-term asset price inflation.

The steady state income return from the national portfolio

The national portfolio described in Section 1 is comprised of real development sites using known or highly certain development costs. The following section details the annual yield that this portfolio could be expected to deliver based on similarly grounded rent and cost assumptions provided by each housing provider.

There are a range of yields that property investors typically consider in assessing the relative attractiveness of a proposition. For the purposes of this report we concentrate on three, and for consistency define them as follows:

Gross Yield - total rental income achievable, assuming 100 per cent occupancy relative to total cost of development

Net Yield - gross yield less costs of managing property including management, maintenance, letting, and operating costs, relative to the total cost of development

Net Operating Income - Net Yield less the reduction in rent received due to some units being void of occupants for any period due to refurbishment or delays in letting (100 per cent -actual occupancy rate = void) and lost rent due to bad debts.

While a higher gross yield is universally positive in terms of maximising returns, variations in costs, occupancy and bad debts, mean that it is not necessarily the case that a development with a higher gross yield will not necessarily have a higher net operating income.

Overall, the portfolio could be expected to deliver a final net operating income of 3.9 per cent at steady state relative to the total cost of development based on a 30 per cent gross to net reduction to account for the costs of management, maintenance, lettings, voids and bad debts (see Table 3). With one of the objectives for the housing providers being the ability to recycle capital, this return is an initial starting point for determining whether the financial returns are sufficient to attract institutional investment, a topic dealt with in more detail in the second half of this section. How the 3.9 per cent income return is arrived at is discussed below. Table 3 provides a summary of the steady state yield that the national portfolio delivers.

Table 3: Steady State Yield Summary: The National Portfolio

	Aggregate per annum (£)	% of Gross Rent	Per Unit Per Annum (£)	Per Unit Per Week (£)
Total Gross Rent	**£7,805,269**	*100.0%*	10,032	193
Gross Yield	***5.6%***			
Management Costs:				
Responsive Maintenance	(£403,671)	*5.2%*	519	10
Planned Maintenance	(£583,707)	*7.5%*	750	14
Regulatory & Other	(£147,440)	*1.9%*	190	4
Relet Costs	(£37,215)	*0.5%*	48	1
Lettings Costs	(£176,253)	*2.3%*	227	4
Organisational Overheads	(£597,073)	*7.6%*	767	15
Total	**(£1,945,360)**	***24.9%***	**2,500**	**48**
Net Rent	**£5,859,909**	***75.1%***	**7,532**	**145**
Net Yield	***4.2%***			
Voids	(£283,623)	*3.6%*	365	7
Bad Debt	(£126,982)	*1.6%*	163	3
Net Operating Income (NOI)	**£5,449,304**	***69.8%***	**7,004**	**135**
NOI Yield	***3.9%***			

Notes:

1) Total development costs have been used as a proxy for value in calculating yields

Total Gross Rent: £7.8m

The total gross rent of the combined portfolio of 778 units across 16 developments is £7.8m. This figure assumes all units are occupied fully (100 per cent occupancy). Housing partners have provided for each development estimates of rent levels for each property type, allowing for the number of bedrooms and whether the property is a house or flat. These rent estimates have been made with reference to local market conditions, and benchmarked against market rental levels for similar properties in the appropriate local area. No adjustments have been made to these rent levels in light of the improved offer to tenants described in Section 1 (better security and higher quality management). This gross rent level delivers a gross yield of 5.6 per cent relative to the total cost of development of £140m.

Management Costs: £1.9m (24.9 per cent of gross rent)

Management costs comprise a range of costs including:

Responsive maintenance - dealing with day to day repair jobs as they arise

Planned maintenance - costs required to continually maintain property, for example replacing windows or kitchens, against an agreed replacement cycle

Regulatory costs - these include a range of items such as annual testing of smoke alarms, gas and electrical appliances

Relet costs –costs that tenants are typically responsible for but that have to be covered by landlords during void periods, for example council tax

Letting costs –costs associated with marketing and letting properties

Organisational overheads - central costs for co-ordinating and managing the above activities.

The above figures are inclusive of relevant VAT at 20 per cent.

We have assumed that each housing provider will continue to manage the specific units it develops and will sign a separate Operations and Maintenance contract with the investor or investment fund. The housing partners have provided the management costs shown in Table 3 on the basis of actual spending, using unit costs from their existing, in many cases extensive, repairs, maintenance and lettings businesses. It is worth noting that these costs have also been provided on the basis that these would be levels at which housing partners would be willing to contract externally with the investment vehicle.

This portfolio modestly outperforms the industry benchmark as measured by IPD, with a weighted average management cost of 24.9 per cent compared to the 27 per cent to 33 per cent identified by IPD dependent on the region.[16] This outperformance is driven by three factors: 1) the portfolio is entirely new build which requires less intensive management and capital investment, particularly in the early years; 2) the national portfolio is made up of developments which are concentrated in single locations which allows for more efficient management; and 3) housing providers have focused their private rented developments in areas where they already have existing management infrastructure through their social housing activities and are therefore able to exploit economies of scale. A fuller discussion of the challenges of estimating management costs for the build to rent market is provided in the project's interim report: *The challenges of build to rent for UK housing providers*.

Net rent of £5.9million equals total gross rent of £7.8million less the £1.9million of management costs. This delivers a net yield of 4.2 per cent.

Voids: £0.3m

Voids represent the costs of a property not being occupied. Voids do not represent a cash cost, rather they represents the lost rent due to a unit not being occupied for a specific period of time. In turn this reflects two features: 1) the time between tenancies for which a property is empty; and 2) the length of time a tenant remains in the property. Voids to a certain extent are unavoidable, and in some cases are desirable as they allow a landlord access to a property to undertake necessary maintenance work. At the same time, voids can vary significantly between landlords, and good management would look to minimise voids as much as possible.

The void percentage of 3.7 per cent is based on an average time between tenancies of 21 days, and an average tenancy length of 19 months. Data from the Association of Residential Lettings Agents suggests that the average length of stay at the same property for a tenant in the private rented sector is around 19 months (1.6 years), and has been steadily rising over the past seven years. While this is significantly shorter than that for a tenant in social housing (8 years) or for an owner-occupier (13 years)[17] it is also significantly longer than the average fixed term of an AST contract of between six and 12 months.

A central assumption of the national portfolio as discussed previously is that to help improve security for tenants, units would be offered on the basis of longer tenancies. However, the evidence on whether a longer tenancy results in individuals and families staying for longer than average is still very limited, hence the use of an average tenancy length of 19 months to estimate void costs.

[16] IPD UK Residential Investment Index
[17] *Source: DCLG: English Private Landlords Survey 2010*

Bad debts: £0.1m

Bad debts represent an additional cost of £0.1m, equivalent to 1.6 per cent of gross rent. This equates to the level of rent that should be paid, but is not received due to non-collection or arrears. Housing partners have provided their best estimates for this figure based on existing PRS schemes, or by using as a starting point data from their social housing portfolios.

Net Operating Income: £5.4m

Net rent of £5.9 million less voids and bad debts gives a net operating income for the portfolio of £5.4m, equivalent to a yield of 3.9 per cent relative to the total cost of development. The total reduction from gross rent equals £2.4m, constituting a gross to net reduction of 30 per cent.

The income return of 3.9 per cent provides a starting point for assessing the portfolio as an investment proposition. We now go on to look at the total return from the portfolio and assess the extent to which these returns meet investor expectations.

Total returns from the portfolio

As we discussed in the previous section, if build to rent is to work for institutional investors, it will need to do so on the basis of a stable income return that also provides an important hedge against inflation. However, certain types of investors will also judge the asset on the basis of capital growth, however uncertain, and for that reason, we present the total return picture here.

The total return to an investor over time includes both the annual net operating income yield and also the change in the underlying value of the properties. The previous section highlighted that the national portfolio would offer an initial net operating income of £5.4m, 3.9 per cent of the total cost of development.

Our baseline assumption is that rent will move in line with CPI and that management costs will do the same. Using a CPI inflation forecast of 2.5 per cent, both nominal rental and cost inflation would therefore be 2.5 per cent. We make the same assumption for capital appreciation assuming the value of properties increases in line with CPI over the medium term. In effect, the base assumption is that there is no real increase in rents, costs or capital values.

The national portfolio offers investors an annual return of around 6.5 per cent allowing for both income and capital appreciation in line with CPI at 2.5 per cent over the medium term.[18] One way to improve the return would be to focus on areas where expected capital and rental inflation is higher. Table 4 presents a sensitivity analysis of the impact of inflation on both rent and capital value. A one percentage point increase in both rental inflation and capital appreciation increases the total investor return (IRR) from 6.5 per cent to 7.6 per cent.

[18] For the purposes of analysis a 10 year investment horizon has been modelled, and used throughout this report for consistency. As noted below, a fixed investment term does not appear to be an initial investor priority. It should also be noted that the impact of a long investment period are minimal relative to the return figures presented.

Table 4: Sensitivity of total investor returns to rental inflation and capital appreciation

Capital Appreciation (p.a.)	Rental Growth (p.a.) 1.0%	2.0%	2.5%	3.0%	3.5%	4.0%	4.5%	5.0%
1.0%	4.8%	5.1%	5.2%	5.4%	5.5%	5.7%	5.8%	6.0%
2.0%	5.6%	5.9%	6.0%	6.2%	6.3%	6.5%	6.6%	6.8%
2.5%	6.1%	6.3%	**6.5%**	6.6%	6.7%	6.9%	7.0%	7.2%
3.0%	6.5%	6.8%	6.9%	7.0%	7.2%	7.3%	7.4%	7.6%
3.5%	6.9%	7.2%	7.3%	7.4%	7.6%	7.7%	7.9%	8.0%
4.0%	7.4%	7.6%	7.7%	7.9%	8.0%	8.1%	8.3%	8.4%
4.5%	7.8%	8.1%	8.2%	8.3%	8.4%	8.6%	8.7%	8.8%

Note:

Returns calculated over 10 Yr Investment Length, no debt, returns pre-income or profit tax, cost inflation assumed at 2.5% p.a.

How do our base case returns compare to investor expectations?

Setting out return expectations is complex, not least because the term "investors" covers an enormous range of money managers with vastly differing investment mandates. A sovereign wealth fund will have very different requirements to that of a hedge fund or indeed a traditional mutual fund manager. Even within comparable groups, for example pension funds, investment requirements can differ substantially depending on the wider requirements of the funds under management. There is also a subtle, but important difference between return aspirations and realistic return expectations.[19]

What is clear however is that the impact of historically low interest rates and quantitative easing have driven bond yields to record lows, and this is encouraging asset managers to search for alternative sources of income. Build to rent as an asset class is of particular interest because it offers a potentially low correlation to other asset classes, generating opportunities for diversification. Furthermore, it also offers some form of long-term linkage to or protection from inflation, even if not contractual, something which is of significance to those working to meet future inflation-linked defined benefit obligations.

A broad range of investors provided extensive contributions in identifying the critical requirements that a national portfolio of build to rent would need to achieve. These conversations highlighted that on an unlevered basis, the national portfolio would need to deliver a running yield of at least 4 per cent and a total return (IRR) in the indicative range of 6 to 10 per cent. While this suggests the national portfolio is viable, the returns sit at the low end of the indicative range and at this level, attracting external institutional investment is in no way guaranteed. As we have discussed, one way to improve the return would be to focus on areas where expected capital and rental inflation is higher. However if the aim of developing build to rent is to increase supply and so reduce the squeeze on household finances that we have witnessed over the past decade, then it would be inconsistent to rely on higher rates of rent inflation or capital appreciation to underpin the viability of market rent as an investment proposition. An initial assumption of 2.5 per cent is one that balances the desire to offer an affordable tenure for renters with viable returns for investors. There also seems to be no clear justification for forecasting a long term divergence in cost and income trends. Based on investor feedback this seems an appropriately conservative set of initial assumptions over the medium terms. A more detailed discussion of ways to enhance returns is undertaken in the next section.

Discussions with investors also highlighted a number of important majority consensus views which have potentially wider relevance for those looking to attract institutional investment into build to rent and have shaped the baseline assumptions we have made. These are detailed below.

[19] Authers, J. (2013) Markets: The investors dilemma, *Financial Times*, 10th July.

Higher perceived risk requires higher expected return

Generally, an investor willing to take on more risk will require a higher expected return. There are a significant number of risks in developing and running a national portfolio of market rent accommodation. Investors expressed a preference to invest post stabilisation of the portfolio. Stablisation is defined as the point after the development has been completed, once occupancy rates have reached a pre-defined level, say 95 per cent occupancy. Housing partners were viewed as better placed to manage risks in developing and stabilising a portfolio given their development experience and local market knowledge but were not expected to provide a guarantee for on-going voids, bad debts and rent levels.

Forward funding commitments were frequently identified as a means to help manage the exit risk for housing providers. These ensure funding is available once the development is stabilised and delivering an agreed initial return. Without such forward funding commitments, the housing providers would likely require a higher developer margin than the 5 per cent used in this model. Table 5 below shows the sensitivity of the returns to different levels of developer margin. A commercial margin of 20 per cent in contrast to the 5 per cent assumed here would bring the NOI yield down from 3.9 per cent to 3.4 per cent and take 0.5 per cent off the total return (IRR).

Table 5: Sensitivity of returns to developer margin

	Developer Margin					
	0%	**5%**	**10%**	**15%**	**20%**	**25%**
NOI Yield	4.1%	**3.9%**	3.7%	3.6%	3.4%	3.3%
Total Investor Return	6.7%	**6.5%**	6.3%	6.1%	6.0%	5.8%

Note: Returns calculated over 10 Yr Investment Length, no debt, returns pre-income or profit tax, rental, capital and cost inflation assumed at 2.5% p.a.

Scale is important

Scale has been widely identified as one of the key barriers to institutional investment in build to rent. Scale matters both from an operational and financial perspective. Larger portfolios of units can be managed more efficiently, but also allow the costs of due diligence and on-going monitoring to be spread across a larger investment. A minimum investment size of £70 to £100 million was commonly identified as desirable.

Capital structure – unlevered in base case

Investor return requirements were typically described on an unlevered basis, with many investors highlighting that leverage is a secondary consideration that could be introduced if required at a later stage. We discuss the model's sensitivity to leverage in Section 4.

No requirement for pre-determined investment term length

Investors signalled that there was no need to have a pre-determined investment term length. Institutional investors have the potential to realise capital gains at different points in time through the sale of a share of the investment vehicle, use of debt refinancing or through underlying asset sales. Investment horizons of investors as noted before can also differ significantly. Consequently a defined investment length was not viewed as critical, although there was general consensus that investment would be viewed over a medium term (5+ year) horizon.

Alignment of incentives between parties is important

Building and managing a national portfolio of market rent accommodation involves a wide range of potential parties whose priorities are not necessarily aligned. Aligning incentives is important in that it helps both reduces risks, but also maximise returns. In this context, investors generally expressed a preference for the housing providers to retain a minority equity stake of around 10 per cent in the final investment vehicle. This would help align the interests of the providers as housing managers with those of investors independent of any O&M contract and allow providers to share in the long term success of the project. It would encourage those engaged in development to optimise life cycle cost considerations during the initial design and build phase and would also help ensure that the development fits with the longer term needs of the local population and wider regional housing strategy.

The investment vehicle should be tax transparent

The choice of investment vehicle will be ultimately defined by the investor depending on a range of issues including: investor status (retail or institutional); liquidity requirements; tax status; investment time horizon; scale of investment; gearing level; whether the investor intends to acquire the portfolio in its entirety or to invest in a fund or joint venture.

Almost regardless of the answers to the above, what matters is that the vehicle is tax transparent i.e. that tax is levied on the underlying investor rather than on the vehicle itself. This ensures that investors with different fiscal status can invest in a common vehicle without compromising one another, and avoids any double taxation of income. There are a number of potential investment vehicles available to achieve this, including Real Estate Investment Trusts (REITS), Property Authorised Investment Funds (PAIF), Jersey Property Trusts (JPUT) or English Limited Partnerships (ELP). Each has its own advantages and limitations and discussions with legal advisers highlighted that the national portfolio could potentially fit into any of them if desired.

This section has demonstrated that the national build to rent portfolio we have put together can meet investor return expectations at the lower end but that the ability to secure institutional investment would not be guaranteed. Therefore, in the next section we look at strategies for improving investor returns to create a more compelling build to rent proposition.

Section 3: Scheme optimisation

As discussed in Section 2, the 6.5 per cent total investor return generated by the national portfolio is acceptable, but arguably marginal relative to investor objectives and so in this section we look at optimising the scheme. This optimisation is based on best execution rather than on any assumed changes to the existing policy, fiscal or regulatory regime. There is, therefore, no change to VAT, SDLT or capital allowances and no change to the 5 per cent developer margin or to the base funding costs for the housing providers, both of which would be negatively affected by any changes to the regulation of RPs' market-based activity. In the interests of affordability, we do not make any changes to the inflation assumptions made in the base case.

Instead we focus on site selection, reducing land costs, reducing build costs and increasing average length of stay by tenants. Each measure is considered in isolation to identify the magnitude of difference that each could make to base case returns and we then look at the combined impact of these changes.

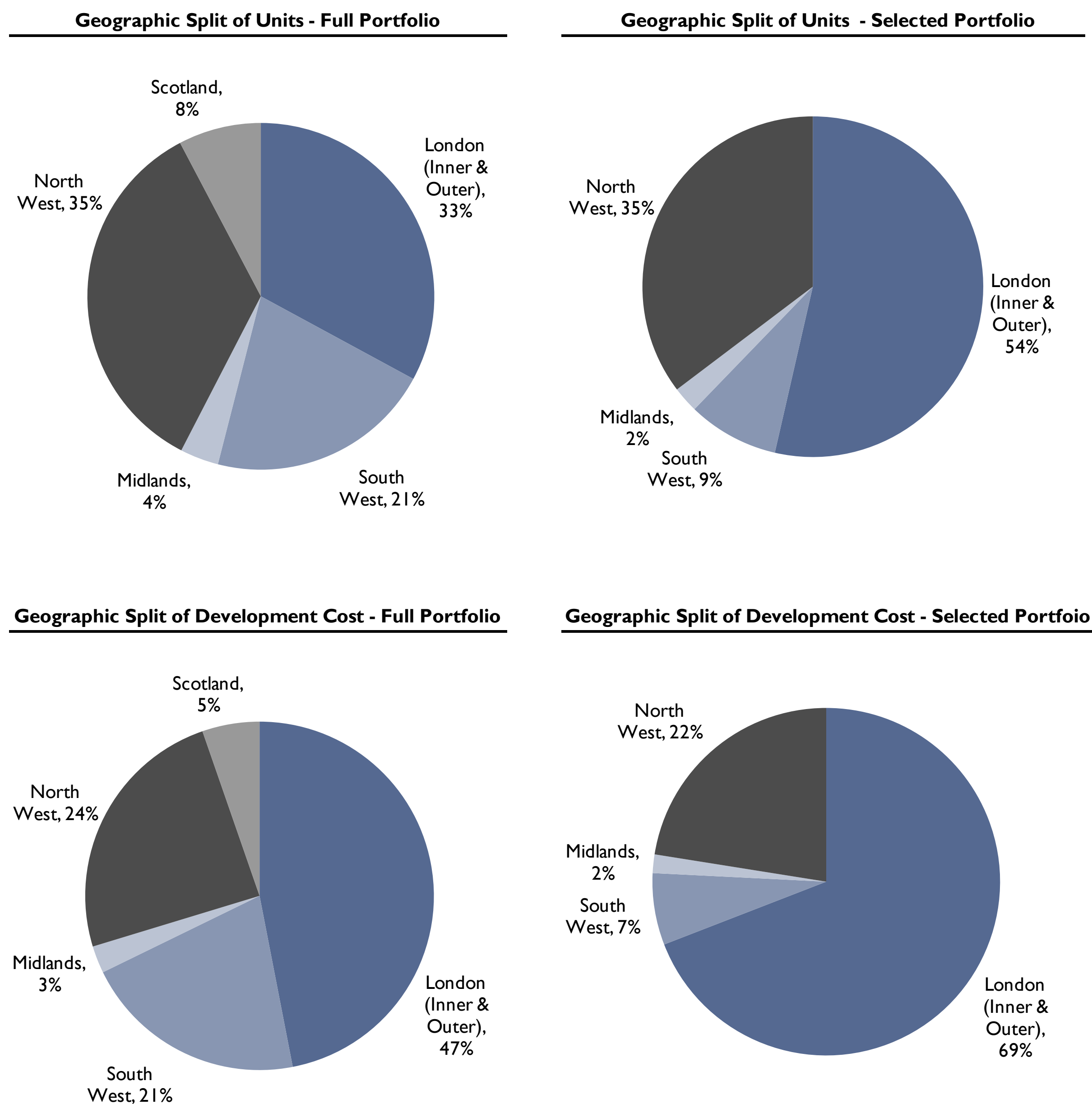
1. Site selection

The 16 developments included in the base case portfolio were selected by each housing partner on the basis that they were appropriate for market rent development, although no returns threshold was set for sites to be included. It is clear that some of the 16 developments are more profitable than others and so removing the less profitable sites will drive returns higher.

If we select those sites from the overall 16 that achieve at least a 4 per cent NOI yield on the basis that this was regularly cited by investors as a sound NOI yield, seven sites make it into the "selected portfolio".

In terms of portfolio characteristics, geographic spread moves in favour of London, but the Midlands and the North West retain a reasonable presence at 37 per cent of units and 24 per cent of development cost (see Figure 7). The geographic shift towards London also means that the selected portfolio is more weighted towards higher rent developments which makes it less suitable for modest income families and situates it more firmly as a middle income product.

Figure 7: Geographic split of units and development costs in the base case and selected portfolios



Meanwhile, development value falls from the original £140m to £75m based on 405 rather than 778 units as shown in Table 6 but likely retains sufficient scale to remain of interest to most investors, particularly given the higher yield. Operational and management scale gains would be unchanged given that, as discussed in Section 1, these are determined by the scale of each housing providers' combined housing stock in the area, rather than by the size of the investment portfolio itself. Table 7 shows the steady state yield for the selected portfolio.

Table 6: Development value of the base case and selected portfolios

Development Characteristics - Full 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%
Outer London	152	20%
South West	164	21%
Midlands	28	4%
Northwest	270	35%
Scotland	60	8%

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)**

Development Characteristics - Selected Portfolio

Unit Summary	Number	% of Total Units
Total Units	**405**	**100%**
By Unit Type:		
Studios	0	0.0%
1 beds	45	11%
2 beds	215	53%
3 beds	134	33%
4 beds	11	3%
By Region:		
Central London	65	16%
Outer London	152	38%
South West	35	9%
Midlands	10	2%
Northwest	143	35%
Scotland	0	0%

Development Costs:	Aggregate	Average by Unit
Construction Costs	(£45,356,758)	(£111,992)
Land Costs	(£14,590,734)	(£36,027)
Other Development Costs	(£5,276,747)	(£13,029)
Administrative, Regulatory and Other	(£6,403,220)	(£15,810)
Developer Margin	(£3,581,373)	(£8,843)
Total Development Costs	**(£75,208,833)**	**(£185,701)**

Table 7: Steady state yield summary for the selected portfolio of seven developments

	Aggregate per annum (£)	% of Gross Rent	Per Unit Per Annum (£)	Per Unit Per Week (£)
Total Gross Rent	**£4,531,180**	*100.0%*	11,188	215
Gross Yield	***6.0%***			
Management Costs:				
Responsive Maintenance	(£233,929)	*5.2%*	578	11
Planned Maintenance	(£301,996)	*6.7%*	746	14
Regulatory & Other	(£97,734)	*2.2%*	241	5
Relet Costs	(£12,680)	*0.3%*	31	1
Lettings Costs	(£75,276)	*1.7%*	186	4
Organisational Overheads	(£383,226)	*8.5%*	946	18
Total	**(£1,104,841)**	***24.4%***	**2,728**	**52**
Net Rent	**£3,426,339**	***75.6%***	**8,460**	**163**
Net Yield	***4.6%***			
Voids	(£167,298)	*3.7%*	413	8
Bad Debt	(£73,717)	*1.6%*	182	4
Net Operating Income (NOI)	**£3,185,324**	***70.3%***	**7,865**	**151**
NOI Yield	***4.2%***			

Notes:

1) Total development costs have been used as a proxy for value in calculating yields

Using the steady state yield summary above we can examine the areas driving return improvements in the selected portfolio versus the base case portfolio shown in Table 3.

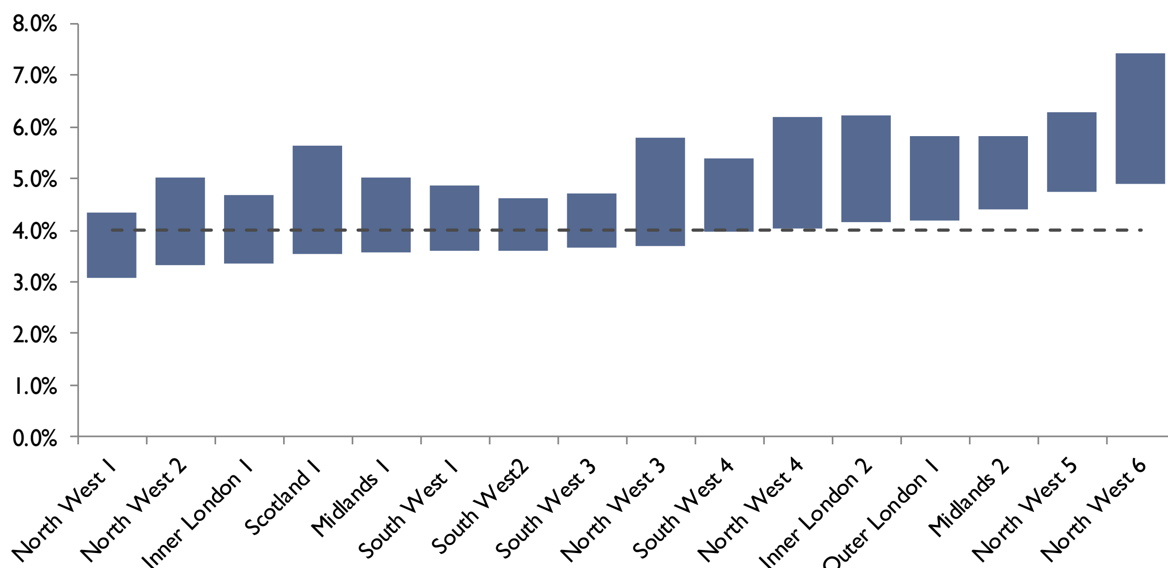
Gross yield

The first area driving a higher return is the higher gross yield of 6.0 per cent compared to 5.6 per cent in the base case portfolio which in part reflects a higher weekly rent of £215 compared to £193. However, this is not a simple story of higher rents delivering higher returns. One of the highest rent developments in the base case portfolio fails to make it into the selected portfolio, while a development with rents in the bottom quartile of our group does. This is because rent has to be considered in the context of the land and development costs of the project. London developments, for example, charge the highest weekly rents but do not always deliver the highest gross yields as elevated land and build costs bear down on the profitability of the project.

Management costs

The second driver of improved returns in the selected portfolio is management costs which come in at 24.4 per cent of gross rent compared to 24.9 per cent. Indeed there are a number of developments with apparently attractive gross yields that fail to meet the 4 per cent NOI hurdle used for this selected portfolio because the cost-to-income ratio of the development is simply too high. This is illustrated in Figure 8 below which charts the gross to net fade of each development.

Figure 8: Gross yield to net operating income yield reduction across the 16 developments in the base case portfolio.



The top of each bar in Figure 8 represents the gross yield from each development within the portfolio, while the bottom of the bar represents the NOI yield. In some cases, those developments that start far above the 4 per cent cut off for the selected portfolio (for example, Scotland 1 and North West 3) fall below it once management costs and bad debts are taken into account.

The combination of these operational improvements results in a running yield for the selected portfolio of 4.2 per cent in comparison to the original base case portfolio of 3.9 per cent.

2. Land costs

Across the portfolio of 16 developments, land accounts for on average around a fifth (21 per cent) of overall development costs and ranges from 4 per cent to 44 per cent across the individual schemes, with

London developments dominating the top end of that range. Land acquisition is regularly cited as a challenge in PRS development, particularly as build to rent developers are pitted against those who build to sell, which means land prices are set by the higher return "for sale" market. Effective use of the proposed system of covenants to distinguish between the residential for sale and for rent markets ought to relieve some of the competitive pressure on land acquisition.[20] For the purposes of this optimisation exercise, we assume a 15 per cent reduction in land costs which, while helpful at the margin, delivers only a 0.1 per cent increase in NOI yield and has a similar impact on the prevailing 6.5 per cent total return (see Table 8).

Table 8: Senstivity of investor returns to changes in land costs

	Land Cost				
	-15%	-10%	0%	10%	15%
NOI Yield	4.0%	4.0%	**3.9%**	3.8%	3.8%
Total Investor Return	6.6%	6.6%	**6.5%**	6.4%	6.3%

Note: Returns calculated over 10 Yr Investment Length, no debt, returns pre-income or profit tax, rental, capital and cost inflation assumed at 2.5% p.a.

3. Build costs

Build costs account for the majority of development costs – 59 per cent in the base case portfolio - so any efficiencies that can be made as the sector develops and reaches scale will improve returns. At present, there is limited understanding in the UK about the way in which build costs for build to rent may vary from either the costs of long term social rented properties or homes for sale. Assumptions vary as to whether build costs will, in fact, be greater given the need for durability but may be reflected in lower management costs or whether a purpose-built product can be built for less.[21] It is possible that in time new building techniques similar to modular build will be adopted by the sector and significantly reduce build costs. This is an important area for cost improvement, but one which is currently high uncertain.

If we assume, for the purposes of this exercise, that standardisation of design and bulk purchasing reduce build costs by 5 per cent, this lifts the NOI yield to 4.1 per cent and the total return (IRR) to 6.7 per cent as shown in Table 9 below.

Table 9: Sensitivity of investor returns to changes in build costs

	Build Cost				
	0%	-5%	-10%	-15%	-20%
NOI Yield	**3.9%**	4.1%	4.3%	4.6%	4.9%
Total Investor Return	**6.5%**	6.7%	6.9%	7.2%	7.5%

Note: Returns calculated over 10 Yr Investment Length, no debt, returns pre-income or profit tax, rental, capital and cost inflation assumed at 2.5% p.a.

4. Tenancy

Voids and letting costs account for over 5 per cent of gross rent in the base case portfolio. Although we assume that tenants will be offered a longer tenancy of between three and five years, this is currently not

[20] The Mayor's Housing Covenant: Making the private rented sector work for Londoners; DCLG (2012) Review of the barriers to institutional investment in private rented homes, London: DCLG.

[21] Alakeson, V. (2013) *The Challenges of Build to Rent for UK Housing Providers*, London: The Resolution Foundation

reflected in the void and lettings costs. Estimating the actual sensitivity of tenancy length and void periods to longer tenancy contracts and greater rent visibility is hard to judge, but it clearly works in both the investor's and the tenant's favour to reduce churn and extend average tenure.

As shown in Table 10, on a stable void period (days during which the property is vacant), an increase in average tenure from 19 months to four years would see NOI yield rise from 3.9 per cent to 4.1 per cent and the total return (IRR) from 6.5 to 6.7 per cent. Furthermore a 10 day increase in the void period spent looking for a long term tenant (from 21 days to 31 days) would be more than compensated for by a 6 month increase in average tenure.

Over time, the impact of longer tenancies on void costs will become more transparent as housing providers begin to understand tenant behaviour. However, it would seem safe to assume that longer tenancies will support improved returns for investors.

Table 10: Sensitivity of investor returns to changes in tenancy length

	Average Tenancy Length (Months)						
	12	**18**	**19**	**24**	**36**	**38**	**48**
NOI Yield	3.7%	3.9%	**3.9%**	4.0%	4.0%	4.1%	4.1%
Total Investor Return	6.2%	6.4%	**6.5%**	6.5%	6.6%	6.6%	6.7%

Note: Returns calculated over 10 Yr Investment Length, no debt, returns pre-income or profit tax, rental, capital and cost inflation assumed at 2.5% p.a.

Combined impact

The above analysis shows the magnitude of improvement from each of the four changes made to the base case portfolio. We next look at the combined impact of all four changes to create a fully optimised portfolio. To summarise, this optimised scheme includes only those developments with a minimum 4 per cent NOI yield and assumes 15 per cent lower land costs in line with the discount on land provided by 'PRS only' residential covenants. We also assume 5 per cent lower build costs. Tenancy lengths are doubled from 19 months to 38 months and void periods are held steady at 21days.

The combined impact of these changes is shown in Table 11 below. The table shows the same scale of development in terms of units and geographic spread as the selected portfolio described at the beginning of this section. What has changed is the overall development cost which has fallen from £75million to £71million due to lower land and construction costs.

Table 11: Development costs of optimised selected portfolio

Development Characteristics

Unit Summary	Number	% of Total Units
Total Units	**405**	**100%**
By Unit Type:		
Studios	0	0.0%
1 beds	45	11%
2 beds	215	53%
3 beds	134	33%
4 beds	11	3%
By Region:		
Central London	65	16%
Outer London	152	38%
South West	35	9%
Midlands	10	2%
Northwest	143	35%
Scotland	0	0%

Development Costs:	Aggregate	Average by Unit
Construction Costs	(£43,088,920)	(£106,392)
Land Costs	(£12,402,124)	(£30,623)
Other Development Costs	(£5,276,747)	(£13,029)
Administrative, Regulatory and Other	(£6,403,220)	(£15,810)
Developer Margin	(£3,358,551)	(£8,293)
Total Development Costs	**(£70,529,562)**	**(£174,147)**

Since total development costs are used as a proxy for value in calculating yields, gross yield increases from 6 per cent to 6.4 per cent while gross rent remains stable at £215 per unit per week. Table 12 below also shows that management costs fall from 24.4 per cent of gross rent to 23.4 per cent, as relet and letting expenses decline on the back of longer tenancies. Additionally voids drop to just 1.8 per cent of gross rent from 3.7 per cent also as a result of the longer tenancy. The combination of these factors takes NOI yield to 4.7 per cent from 3.9 per cent in the original base case and 4.3 per cent for the selected portfolio alone. The total return (IRR) rises to 7.2 per cent from 6.5 per cent for the original base case and 6.8 per cent for the selected portfolio prior to optimisation (see Table 13).

Table 12: Steady state yield summary: optimised selected portfolio

	Aggregate per annum (£)	% of Gross Rent	Per Unit Per Annum (£)	Per Unit Per Week (£)
Total Gross Rent	**£4,531,180**	*100.0%*	11,188	215
Gross Yield	***6.4%***			
Management Costs:				
Responsive Maintenance	(£233,929)	*5.2%*	578	11
Planned Maintenance	(£301,996)	*6.7%*	746	14
Regulatory & Other	(£97,734)	*2.2%*	241	5
Relet Costs	(£6,340)	*0.1%*	16	0
Lettings Costs	(£37,638)	*0.8%*	93	2
Organisational Overheads	(£383,226)	*8.5%*	946	18
Total	**(£1,060,863)**	**23.4%**	**2,619**	**50**
Net Rent	**£3,470,317**	**76.6%**	**8,569**	**165**
Net Yield	***4.9%***			
Voids	(£83,649)	*1.8%*	207	4
Bad Debt	(£73,717)	*1.6%*	182	4
Net Operating Income (NOI)	**£3,312,951**	***73.1%***	**8,180**	**157**
NOI Yield	***4.7%***			

Notes:

1) Total development costs have been used as a proxy for value in calculating yields

It is clear from the optimised scheme presented here that, with careful site selection, and optimisation of existing opportunities, build to rent can offer investors a competitive investment proposition and one that is based on a geographically diverse portfolio not just one concentrated in London and the South East. This selected portfolio offers rents that are within reach of middle income families.

Table 13: Sensitivity of total investor returns to rental inflation and capital appreciation for optimised portfolio

Capital Appreciation (p.a.) \ Rental Growth (p.a.)	7.2%	0.0%	1.0%	2.5%	3.0%	3.5%	4.0%	5.0%	5.0%
	0.0%	4.4%	4.7%	5.2%	5.4%	5.6%	5.8%	6.2%	6.2%
	1.0%	5.2%	5.5%	6.0%	6.2%	6.4%	6.6%	6.9%	6.9%
	2.5%	6.5%	6.8%	**7.2%**	7.4%	7.6%	7.7%	8.1%	8.1%
	3.0%	6.9%	7.2%	7.7%	7.8%	8.0%	8.1%	8.5%	8.5%
	3.5%	7.4%	7.6%	8.1%	8.2%	8.4%	8.5%	8.9%	8.9%
	4.0%	7.8%	8.1%	8.5%	8.6%	8.8%	8.9%	9.3%	9.3%
	5.0%	8.7%	8.9%	9.3%	9.5%	9.6%	9.8%	10.1%	10.1%

Note:

Returns calculated over 10 Yr Investment Length, no debt, returns pre-income or profit tax, cost inflation assumed at 2.5% p.a.

Section 4: Leverage and the role of a government guarantee

As discussed in Section 2, the base case uses an unlevered capital structure. It is assumed that depending on a given investor's appetite for debt finance, leverage can be added at a later stage and that there is no advantage to raising debt through the investment vehicle. The lack of track record of the investment vehicle and its relatively small scale would also support this approach as these factors would tend to increase the costs of debt.

However, access to subsidised lending through a government guarantee would fundamentally change that assumption and it is the role of such a guarantee and the sensitivity of returns to both leverage and interest costs that we consider in this section.

In September 2012 the government announced £10bn of debt guarantees targeted at affordable housing and PRS. The Housing Guarantee scheme sits alongside the Help-to-Buy and Funding for Lending initiatives as part of a wider government effort to tackle the UK's housing shortage. It is available only for new build to rent developments in the UK that have reached practical completion (this is not development finance) and requires that those developments remain within the rental sector for the duration of the loan. The guarantee must be in place prior to breaking ground on a development as the purpose of the guarantee is to enable developments that would otherwise not take place. The aim of the debt guarantee scheme is to "attract investment into the private rented sector from fixed-income investors who want a stable, long term return on investment without exposure to residential property risk".[22]

By stepping in to guarantee repayment of a loan in the event of a default, such a scheme should significantly reduce the financing costs for build to rent projects and so improve returns for investors. Under this scenario it would clearly make sense for debt to be raised through the investment vehicle to access the favourable funding rates.

It is worth noting however, that the market is pressing for clarification as to the nature and strength of the guarantee. If, as in the case of UKRAIL, the guarantee is granted directly to the investor rather than to the issuer and, therefore, investors have a direct call on the UK government, financing costs would likely trade very tight to gilts of equivalent maturity; that is to say, the premium charged relative to lending directly to the government would be small. Building in an adequate margin to ensure commercial borrowing terms and to cover the fee for the government guarantee, based on equivalent schemes we estimate that interest costs could fall as low as 4 to 4.5 per cent for borrowing over 30 years and investors would likely be more debt tolerant.

The table below shows the sensitivity of returns to both levels of debt and interest rates. If debt were raised at 4.25 per cent and the vehicle were levered to 30 per cent (in line with US Real Estate Investment Trusts (REITs) – well established investors in build to rent in the US), the total return to an equity investor (IRR) would increase from 6.5 per cent to 7.3 per cent. If the government guarantee resulted in higher debt tolerance, total equity investor returns could rise to 8.3 per cent at, for example, 50 per cent leverage. Figure 9 shows how interest cover changes as leverage increases from 30 per cent to 50 per cent supported by the government guarantee. Although interest cover is lower with 50 per cent leverage, the presence of a government guarantee is likely to give investors sufficient confidence to accept this lower level of coverage.

[22] https://www.gov.uk/government/policies/improving-the-rented-housing-sector--2/supporting-pages/private-rented-sector

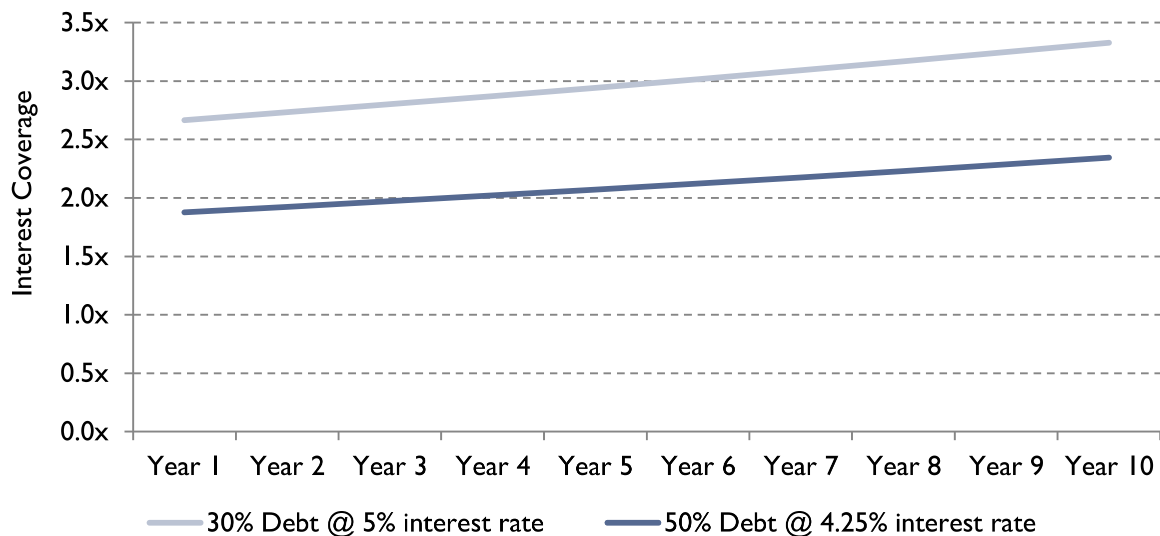
Table 14: Sensitivity of equity investor total returns to leverage and interest rates in the base case portfolio

	Interest Rate						
Leverage %	5.00%	4.75%	4.50%	4.25%	4.00%	3.75%	3.50%
0%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%
10%	6.6%	6.6%	6.6%	6.7%	6.7%	6.7%	6.8%
20%	6.8%	6.8%	6.9%	6.9%	7.0%	7.1%	7.1%
30%	7.0%	7.1%	7.2%	7.3%	7.4%	7.5%	7.6%
40%	7.3%	7.4%	7.6%	7.7%	7.9%	8.0%	8.2%
50%	7.7%	7.9%	8.1%	8.3%	8.5%	8.7%	9.0%
60%	8.2%	8.5%	8.8%	9.1%	9.5%	9.8%	10.1%
70%	9.0%	9.5%	9.9%	10.4%	10.9%	11.3%	11.8%
80%	10.4%	11.1%	11.8%	12.6%	13.3%	14.1%	14.8%

Note:

Returns calculated over 10 Yr Investment Length, returns pre-income or profit tax, cost inflation assumed at 2.5% p.a.

Figure 9: Interest coverage by leverage and interest rate



In the absence of such a robust government guarantee, we would expect interest costs to be significantly higher and so would revert to the base case assumption of an unlevered capital structure with debt added independently by investors.

A robust and credible government guarantee in a relatively new and unproven sector could make a significant difference both to the availability and cost of funding. Table 14 above shows the extent to which lower funding costs could improve returns, but the sensitivity of returns also illustrates the important impact such a guarantee could have on the viability of marginal developments. Sites that would not otherwise be able to deliver a viable build to rent development could be supported through a robust guarantee to meet investor expectations.

Extending a government guarantee should not be taken lightly. The guarantee can lead to a mispricing of risk and a misallocation of capital and ultimately poses a risk to tax payers if the development does fail and creditors call on the guarantee. However, if government does elect to use a government guarantee to

attract investment into the private rented sector, as is the case with the Housing Guarantee Scheme, then it is important that the nature of that guarantee is clear.

Section 5: Improving affordability

The previous sections looked at improving returns for investors, first through optimising the portfolio and best execution and then through the impact of the proposed government guarantee on the costs of leverage. Both deliver significant improvements to the base case returns and together could deliver a highly competitive investment proposition.

At the same time, both could also be used to improve affordability, allowing build to rent to more easily meet the needs of those on modest and even low incomes. Instead of passing on the efficiencies achieved through site selection, lower land and build costs and longer tenancies to investors in the form of higher returns, they could be passed on to tenants in the form of lower rents, while holding returns constant. For example, if the scheme was optimised as described in Section 3 and investor returns held constant at the level achieved by the base case of 3.9 per cent NOI yield and 6.5 per cent total investor return (IRR), it would be possible to achieve a 15 per cent reduction in rent across the selected portfolio.

Close to half of the developments in the base case portfolio already offer rents that are affordable to low income families but they would need additional support to generate a viable investor return. The government guarantee could be used to make lower rent developments viable. This would, in turn, increase the number of places in the country where build to rent could contribute to housing supply.

However, in high cost areas such as London, more will be needed to make build to rent affordable for low income families, while protecting adequate investor returns. To bring developments within reach of low income families would require a substantial reduction in costs. This reduction in cost could be achieved by lowering the price of land.

For example, if rents in the selected portfolio of seven developments were reduced so that a low income couple with one child at the 25th percentile was not spending more than 35 per cent of net income on housing, rents for the London developments would on average need to fall by around £100 a week. In order to maintain the 3.9 per cent income return of the base case portfolio with this new, more affordable rent, land costs – which account for 20 per cent of total development costs - would have to be reduced by a third.

While it is difficult to argue that public land owners should put in land at reduced cost simply to deliver better returns for investors, there may be a strong rationale for using public land to improve the affordability of developments. Here, local authorities have choices to make about the best strategic use of valuable land assets. They could use their land to support build to rent for low income tenants or to support new affordable or social rent developments. The extent to which they may prioritise one over the other will depend on their particular local context. They may have a strategic, local need for long term rented accommodation for working families who would not qualify for affordable or social rent. Without active support from local authorities or other public land owners through the use of discounted land, it is unlikely that the market will deliver a build to rent product that meets the requirements of low income families. As a market proposition, build to rent is better suited to modest and middle income tenants.

Summary of findings

While doubts about the attractiveness of returns from build to rent have persisted, our analysis shows that build to rent can deliver a viable investment proposition at a national scale, making an important contribution to housing supply.

- Our analysis demonstrates that the scale of development preferred by institutional investors – between £70 and £100 million or above – can be achieved by pooling developments across different housing providers to create a national portfolio of 16 developments and 778 predominantly market rent units.
- As well as contributing to supply, the national portfolio can provide purpose-built and designed accommodation that is professionally managed. It can provide longer tenancies with more transparent and predictable rent increases that meet the affordability requirements of modest and middle income tenants.
- A national portfolio of this kind achieves a steady state income return of 3.9 per cent relative to the total costs of development on the basis of a 30 per cent gross to net reduction. This gross to net reduction includes the costs of management, maintenance, lettings, voids and bad debts.
- An income return of 3.9 per cent and a total investor return of 6.5 per cent over a ten year period (based on 2.5 per cent rental and cost inflation) is acceptable but at the lower end of what investors expect and, therefore, institutional investment may be difficult to secure.
- The expected income return can be improved through site selection, reducing build and land costs and increasing average tenure. Focusing on the 7 sites of the original 16 that deliver at least a 4 per cent NOI yield coupled with a 5 per cent reduction in build costs and a 15 per cent reduction in land costs and tenancies of 38 rather than 19 months can deliver an attractive income return of 4.7 per cent and a total return of 7.2 per cent on a comparable basis.
- However, by focusing on higher yielding sites, the optimised portfolio of only 7 sites is better suited to middle rather than modest income tenants. The optimised portfolio is more heavily weighted towards London where rents are higher.
- Returns can be further improved if a robust government guarantee is available and gearing added. Assuming an interest rate of 4.25 per cent and 50 per cent gearing, the government guarantee would push up the return to an equity investor in the base case portfolio from 6.5 per cent to 8.3 per cent.
- The government guarantee could also be used to make sites that would otherwise not be viable attractive for investors. This, together with a partial discount on land costs, could help to make build to rent a tenure that is also able to meet the needs of low income tenants.

Section 6: Conclusions and recommendations

Despite evidence of a competitive investment proposition and government action to stimulate build to rent over the last year, to date the number of schemes that have secured institutional investment is small and generally focused on the young professional or higher income rental markets in London. To encourage greater activity in other parts of the country and to ensure that build to rent delivers a product aimed at less well-off tenants, concerted action will be required from the different stakeholders involved: national and local government, housing providers and investors.

The specific steps each stakeholder could take to stimulate build to rent are set out in the recommendations below. While the analysis presented in this report is based on development and management costs and rents provided by six housing partners on actual or pipeline developments, the recommendations presented below represent the views of the authors only.

Department for Communities and Local Government

1. While the government has been committed to build to rent, there have been mixed messages about its housing priorities over the last six months. The announcement of the Help to Buy scheme at this year's Budget with its strong support for home ownership made some investors and housing providers nervous about taking bold steps into build to rent. Going forward, creating a new purpose-built market rented sector will require government to demonstrate consistent leadership and commitment to build to rent.
2. The Department for Communities and Local Government is currently consulting on proposed National Planning Practice Guidance. This guidance proposes that local authorities adopt a differentiated approach to assessing the viability of housing schemes which takes into account the different economics of build to rent and build for sale. In doing so, local authorities would ensure fairer competition in the purchase of land between market rent and for sale developments. We would support the adoption such an approach to planning to stimulate build to rent.
3. As we have seen, the government debt guarantee offers the potential to significantly improve returns through leverage or allow a build to rent product to be viable in more places across the country. The exact nature and strength of the government guarantee is gradually becoming clear to market participants and it will be important that the Department for Communities and Local Government takes a flexible approach in deciding which schemes qualify for the guarantee in order to maximise its potential.
4. There is currently a shortage of long term debt funders who are active in the build to rent market which could limit the scope for using the guarantee. The Department for Communities and Local Government needs to continue to raise awareness of build to rent among long term lenders and encourage them to enter the market, building on the establishment of the PRS Taskforce in 2012.

HM Treasury

1. With rent on a let residential property exempt from VAT, VAT on costs is therefore currently irrecoverable. VAT at 20 per cent levied across repairs and management costs has a negative impact on the profitability of residential investment. While there are significant implementation issues with zero rating VAT for repairs and management costs, there is a strong case for HM Treasury to explore ways to support high quality asset managers by helping minimise

irrecoverable VAT. One possible route might be through further changes to the existing shared services regime to exempt services provided by housing providers to an institutional investor or investment vehicle. Fully addressing irrecoverable VAT would help the NOI yield on the national base case portfolio improve from 3.9 per cent to 4.1 per cent.

Homes and Communities Agency and Greater London Authority

1. The Homes and Communities Agency (HCA) and Greater London Authority should use their public land disposal strategies to kick start build to rent by designating some public land sites as 'PRS only'. A covenant on public land can be enforced through a development agreement.
2. As regulator, the Homes and Communities Agency should ensure that it adopts an approach to regulating Registered Providers that protects their ability to pursue market activity on a favourable basis by drawing on their corporate covenant. We would support the regulator not imposing a strict firewall between the core social housing activities of RPs and their market activities except in exceptional circumstances. This proportionate approach will protect the ability of the majority of RPs to diversify their funding base, recycle their balance sheets and extend their social mission to house those modest and middle income families who are poorly served by the current market.

Local Authorities

1. Local authorities must play an active role in planning for the overall needs of their communities and connecting up planning policy, housing affordability and the wider economic needs of their local residents. Rather than focusing predominantly on securing adequate social housing, they must take a broader strategic view of how different tenures, including market rent, can work together across a local area to meet different needs and different levels of affordability. They should proactively use planning and other policies to ensure that they get the new build to rent supply in their area that matches the needs of their local communities.
2. Local authorities should adopted a differentiated approach to planning requirements, such as Section 106, in order to ensure fair competition in the price paid for land between build to rent schemes and build for sale. However, in doing so, local authorities should ensure that this enables new schemes to be brought forward that create additional supply which overall adds to the delivery of affordable housing rather simply lowering S106 requirements on all new developments.
3. Local Authorities should make appropriate use of existing flexibilities in the development of 'best value' justifications for the use of local authority land for build to rent. While 'best value' is often equated with highest possible price, other economic and social considerations can be factored in to make a strong case for build to rent.
4. Alongside the Homes and Communities Agency, local authorities should use their public land to kick start the development of build to rent where it can meet an identified local need. Local authorities can use development agreements to insist on PRS over other residential developments and can use land as a subsidy if necessary - or as long term patient equity rather than requiring cash upfront - to ensure that build to rent addresses local affordability issues and targets those tenants who are poorly served but strategically important to retain in the local area.

Registered providers and other long term housing providers

1. Site selection is critical to creating a viable investment proposition for build to rent. As our analysis shows, it is not only those places where rents are high that are well suited to build to rent. In fact, if high rents go hand in hand with high costs, a site can still be unviable. As build to rent develops, housing providers will need to develop a better understanding of target markets for market rent. Picking appropriate sites will be integral to creating a vibrant investment market for this new asset class.
2. The nature of tenant management in the private rented sector is another area where experience is currently limited among professional landlords. As build to rent develops, there will be a need for housing providers to become more sophisticated in their approach to lettings, management and service provision to ensure that build to rent does deliver a better quality product for tenants.
3. Build to rent as a bespoke market rent product is new to the UK and, therefore, there is a limited amount known about the extent to which its build and management costs are similar to or differ from homes for sale and social rented homes. This expertise will undoubtedly grow over time as more build to rent schemes are developed. Our analysis shows that optimising build and management costs will have a significant bearing on the viability of build to rent. It will, therefore, be critical for the emerging build to rent sector to be able to optimise its processes over time to maximise potential returns or deliver a more affordable product.
4. While several RPs are actively pursuing build to rent and others have expressed strong interest, it will be important for each RP to identify clearly if build to rent fits within its broader organisational strategy and on what basis. While diversification will be important for the entire sector, build to rent is only one potential route to diversification. Building for sale would also be possible, for example. Our analysis suggests that the strongest rationale for build to rent for RPs is as a clear extension of their social mission as long term providers of housing for groups who are otherwise poorly served by the market. Build to rent provides an opportunity to extend this mission to modest and middle income working families. As a source of cross-subsidy for an RP's core mission, its case is less strong because creating a viable investment proposition depends on taking a reduced developer margin in return for a guaranteed exit. Furthermore, the income contribution from operating contracts is likely to be modest.
5. Registered providers have a critical role to play in kick starting build to rent in the UK by using their existing balance sheet capacity to help fund the development phase of assets, recycling capital by passing ownership onto institutional investors. By drawing on their corporate covenant, they can help reduce the overall funding costs and, therefore, make build to rent more viable as an investment proposition, while securing a long term income stream through the Operations and Maintenance contracts and benefiting from any upside through their own equity stake in the investment vehicle.

Investors

- Investors have a critical part to play in developing build to rent in the UK. While they have traditionally viewed residential property on the basis of total returns, there is a growing understanding that build to rent should be judged principally on the basis of income returns. If build to rent is to increase the supply of quality, rented homes on a sustained basis, it will be important that investors commit for the long term rather than on the basis of quickly realising

capital value through sales. Shifting the perception of residential investment in line with income returns will be important to developing this asset class over time.

- Given that many UK institutional investors have not invested in residential property for many years, with a few notable exceptions, expertise in residential property as an asset class is limited here, although not overseas. From the perspective of risk, return, liquidity and duration, build to rent offers a level of diversification potentially not matched by other investments. Furthermore build to rent has the potential to offer some linkage to inflation, creating opportunities to be used as a medium term inflation hedging asset. Overtime, as UK investors become more familiar with build to rent, it will be important that investors come to recognise the value of residential investment as a separate asset class.

There is an urgent need to increase the supply of housing in the UK. Given that home ownership is now out of reach for large numbers of households in Britain for the medium, if not, long term, purpose-built market rented homes must be part of this growth in supply, alongside more affordable and social housing. This report demonstrates that build to rent offers opportunities for both investors and tenants: a more secure, predictable, professionally managed rental product for modest and middle income tenants and a relatively low risk income return that tracks inflation for investors. With concerted effort from all the relevant stakeholders, this emerging asset class can become an established part of the UK housing market for the future.

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.

For more information on this Briefing Note contact:

Vidhya Alakeson Deputy Chief Executive
vidhya.alakeson@resolutionfoundation.org
020 3372 2953