DTZ Response:
Review by Sir Adrian Montague of the barriers to institutional investment in private rented homes – Call for evidence

March 2012

SUMMARY

DTZ has pleasure in submitting our response to the call for evidence in connection with the Review of the barriers to institutionally investment in privately rented homes. We focus particularly on the issue of how institutional funding can be drawn into the funding of new residential developments for rent.

Our focus on the issue of unlocking institutional investment in new build residential development reflects our view that the UK will be unable to develop the number of new homes needed unless a new source of long term investment is unlocked to support housing development.

The old models of long term financing of new housing development essentially by means of mortgage finance (for privately owned homes) and private debt finance and public funding (for affordable housing), will not, at best deliver, more than 160,000 new homes pa in England over the next 10-15 years; while the requirement is for around 230,000 new homes.

Failure to develop sufficient new homes will produce a raft of undesirable side effects that undermine the Government's deficit reduction strategy; it pushes up the cost of housing, with rents taking a higher proportion of household incomes; it places welfare systems under greater strain, blunting work incentives, and producing worse social outcomes.

There are specific market barriers to the development of a new institutionally funded model of residential development. The most significant of these market failures we term co-dependency. For the new development model to work, the interests of at least half a dozen different partners to be aligned.

A development model has to be established that aligns the interests of the investing institutions, asset managers, managing agents, developers or contractors who build new homes (and their supply chain), land owners and the planning authorities. In seeking to establish the new investment model there is a learning curve and costs will initially be higher and perceived risk will be higher.

Co-dependency is a particular form of market failure, where, while there may be overall public benefits of achieving a certain change in the institutional framework or business model of a particular industry, and each participant will also benefit, but the benefits to each individual party are not sufficient to incentivise them to take the lead in brokering a new business model.

Without public sector leadership and investment the new model will never be established. This paper sets out what the Government needs to do to establish the model. Specifically it needs to de-risk initial investments through use of publicly owned land; it needs to play a role in co-ordination of an initial pilot programme; and address constraints imposed by the fiscal and planning environment. Some element of short term financial incentive may be necessary to establish the initial pilot.

If Government plays its part other barriers to entry will become less significant, particularly the absence of proven track record of investment returns; and concerns that this form of investment will never reach the scale of opportunity that makes the initial up-front investment in establishing specialist expertise worthwhile.

THE NEED FOR INSTITUTIONAL INVESTMENT IN THE RESIDENTIAL SECTOR

The need for an additional, significant source of long term investment in new housebuilding is easily stated.

The CLG's latest household projections for England suggest that over the period to 2031, the number of households in England will increase by around 232,000 households each year.

At the peak of the housing market in 2007-08 the net addition to the stock of housing in England was 207,000 homes. Since 2007-08 the net addition to the housing stock has fallen dramatically:

- In 2008-09 166,000 homes were added to the stock of housing in England
- In 2009-10 the figure was just 129,000 homes
- For 2010-11 DTZ estimate the figure will be around 122,000 homes.

Public funding for housebuilding in the period 2011-15 has fallen by 62% pa compared to the period 2008-11.

The government anticipates delivering 170,000 new homes over the four year Spending Review period, equivalent to 42,500 homes pa. This is lower than the 50,000 new affordable homes delivered in the period 2008-11 (based on housing delivery as reported by the HCA).

It is hard to anticipate any significant increase in public funding for housebuilding in the current decade, given the desire to reduce public sector borrowing.

Local authorities have some headroom to borrow to build new homes under the new Self Financing regime; but it is hard to anticipate output of new local authority homes would exceed 5,000 pa in this decade, without additional central government finance.

In the private sector the capacity of the housebuilding industry has shrunk considerably in the last four years; the industry is now focused on margin and not volume. Development finance is considerably more expensive than five years ago, and much more difficult to access.

The traditional private sector housebuilding model depends greatly on the long term financing of new housebuilding by means of personal mortgages. Homebuyers bought new homes built by housebuilders by taking out mortgages.

Mortgage lending volumes for house purchase remain at about half the level of the decade to 2007. This is a product of deleveraging in the world financial system, which means that wholesale financing is much more limited and completion for retail deposits greater.

At the same time, the change in the economic environment is causing lenders to be much more cautious in lending and borrowers to be more cautious in borrowing. Competition for finance has already led to increases in mortgage rates despite the low bank rate.

Tighter regulation of mortgage lending will prevent lenders from lending as freely as they did in the past; though at present this in unlikely to restrain mortgage lending, since restraint is self imposed.

DTZ's, and market expectations, are that the availability and cost of mortgages will impose a significant constraint on the expansion of new housebuilding, for the rest of this decade; and that tighter regulation of banks implies, tighter credit conditions for the next couple of decades, than in the decade to 2007.

We conclude that in the period to 2025 it is unlikely that either traditional mortgage finance or public financing will permit a significant expansion of new housebuilding in the UK.

Our expectation is that net new housing supply in England will not exceed 160,000 new homes in the period before 2025, unless a significant new source of long term funding for financing housebuilding is brought into play.

Institutional investors play a significant role in the long term financing of new housing development in many OECD nations. There is a strong basis for believing that it should be possible to adapt the UK housing market system to deliver investment returns that would be attractive to residential investors.

DTZ would go so far as to suggest that establishing a mechanism that unlocks institutional investment in the UK residential sector is *essential* if the UK is ever to get close to building enough new homes to meet the requirements implied by anticipated household growth.

The UK Government needs to recognise that it has to create the regulatory and fiscal environment where institutional investment delivers the sort of returns needed by investors. Almost certainly the UK Government has to de-risk or incentivise initial investments.

THE HOUSING CHALLENGE OF THE NEXT DECADE

In the absence of determined and co-ordinated action by government the number of households unable to afford market housing will increase over the next five to ten years. This will be the consequence of weak economic growth and failure to increase housing supply, which will maintain housing costs at a level that many will be unable to afford.

The result will be increasing demands on the public purse and increasing homelessness. More people unable to afford market housing will put greater pressure on existing social housing; demand will spill over into the private rented sector. Housing Benefit and Universal Credit bills will rise. The Government needs to break out of this vicious circle (see Figure 1).

How do you ensure that a higher proportion of the population can find a market solution to their housing requirements? It is a choice between expecting people to spend a higher proportion of their income on housing or reducing the cost of housing. The Government should be seeking to reduce the cost of housing.

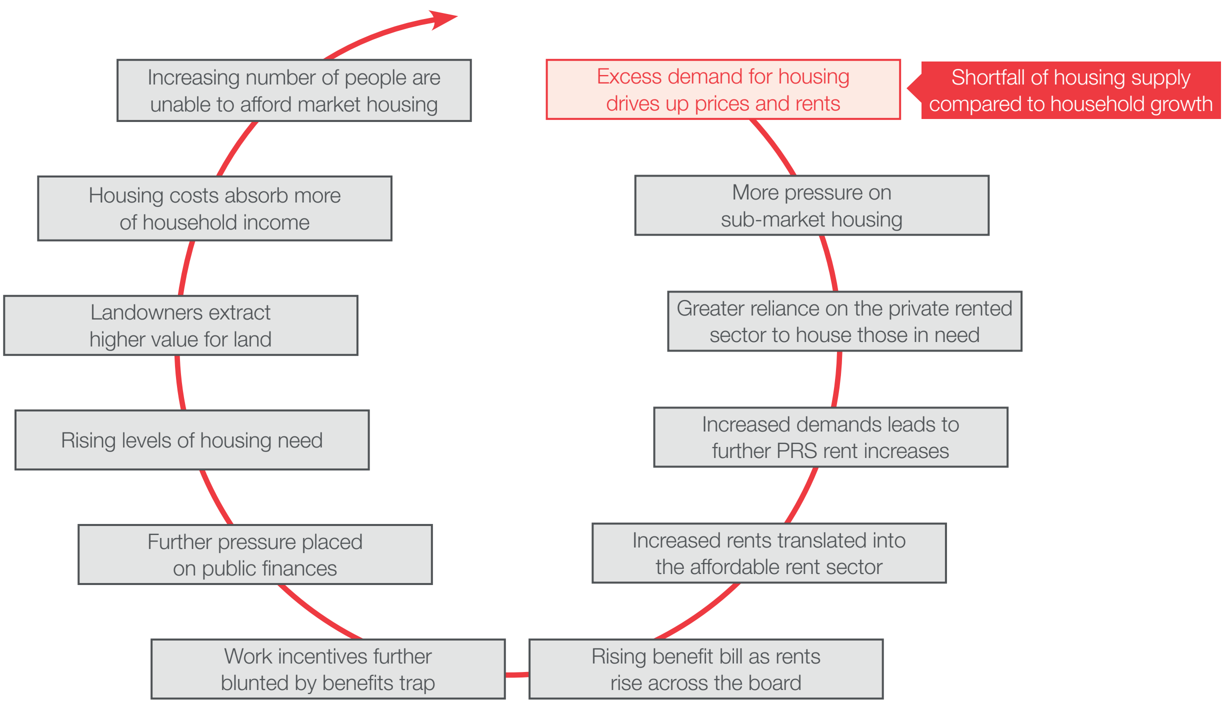
How can it do this? There are two levers to pull:

- Increasing supply – and this fundamentally depends on two factors
  - i) adequate volumes of long term finance to support housebuilding
  - ii) an adequate supply of land.
- Reducing the costs of construction – more homes built per £1m – which again has two components
  - i) increased efficiency in building homes
  - ii) reducing the cost of land required for building homes.

The actions that DTZ believe the government needs to take with respect to these four factors are discussed fully in the DTZ Report *Pulling Up the Ladder 2*, published in November 2011, which has already been made available to the Review Team.

We limit the discussion of the issue in this response to the first issue, long term finance support housebuilding, with is directly linked to the issue of drawing in institutional funding to support new housing development, though each of the other factors are important to making such a new model work.

Figure 1: The Vicious Circle



LONG TERM FINANCE FOR HOUSEBUILDING

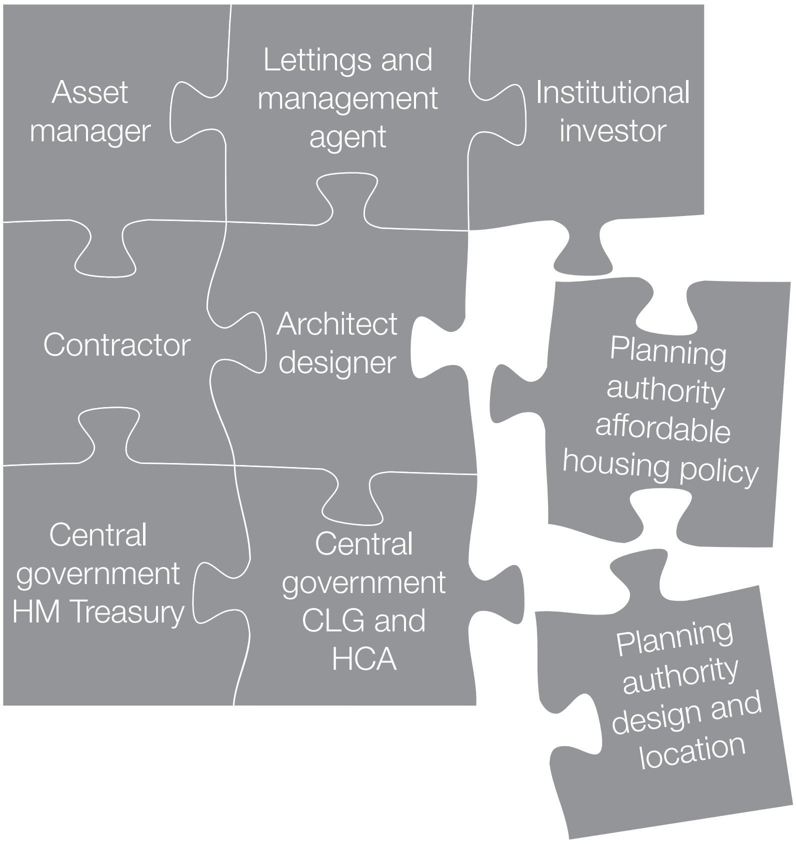
Government needs to take the lead in establishing half a dozen demonstration models of institutional investment in the PRS. This is not something that can simply be left to the market for two reasons.

First, it is too important to wait for the market to come up with a solution. The Government's strategy for increasing housing supply will succeed or fail according to whether institutional funding can be tapped to fund new housing development by providing long term investment funding. The mortgage market is not going to come thundering back – and even if it did return to pre-2007 volumes, that was insufficient to support development of the volume of new homes now needed.

Second, the private sector will fail to come up with a model quickly enough, because establishing a successful model for institutional investment in new build residential development requires co-ordination of at least six different partners. Putting together the model is like a complex Scottish country dance – for it to work everyone has got to know where they are supposed to be at a particular point in the dance, who they are supposed to be turning or reeling with. If one person in the dance does not know what they are doing, it all falls apart.

Figure 2 illustrates the different pieces of the jigsaw that needs to be put together. To establish the model, risk has to be ruthlessly removed, cost stripped out, and ultimately the Government must either gap fund or provide a guarantee that will deliver the rate of return required by the institutional investor. Prove that the model delivers the return and progressively risk can be reduced, and then the Government guarantee or gap funding can be removed.

Figure 2: The Pieces of the Jigsaw



Here is how it needs to work:

- The Government needs to confirm with three or four institutions the nature of the return that they would required from a new build private rented investment, in terms of yield, term and risk profile. The Government then needs to co-ordinate public and private sector partners to come together to deliver an investment proposition that meets these criteria.
- The Government needs to identify publicly owned land suited to the development of new build private rented properties. Potential sites should be discussed with the institutional investors, so they can exercise their judgement as to which sites appeal most to them. Sites with good public transport accessibility in London are likely to be favoured. Government should commit to providing land at nil cost, with the option of retaining the freehold and with a ground rent geared to the performance of the investment.
- Government and the institutions should be involved in appointing contractor/developers to design and cost new homes – probably flats in the first instance – that are specifically designed for private renting: that is, they take into account both the requirements of tenants and the need for cost effective long term maintenance and management. The carrot to get a range of contractors involved would be that when the model takes off those firms will have first mover advantage. It should be possible to ensure that private sector partners come forward with offers to design and build developments at a keen rate.
- The Government will need to ensure that the scheme proposals have the full backing of the local planning authority. New build mid-market rental properties that are to be built cost effectively may not look like conventional market developments. Willingness to accept a different form of development will be required.
- In addition the planning authority must provide total flexibility with respect to provision of affordable housing. If some element of affordable housing enhances the financial performance of the model, well and good; if it does not then the development should be allowed to proceed on the basis of providing 100% market rented homes for mid-market renters. There is a strong rationale for this in that the profile of mainstream private renters is very similar to those targeted as low cost home owners – and intermediate housing products such as shared ownership are treated in planning terms as affordable housing.
- The institutions, working with the government, need to identify asset managers who will be responsible for the overall management of the asset. They need to be tied into the overall contractual arrangements on a clear fee basis.
- Once each element of the proposed development is in place – site, design, planning permission, an agreed build cost and agreed management fee – then the overall investment performance of the proposed development can be assessed. The final stage is to secure the agreement of the institution to buy the development on completion. The Government needs to be willing to underwrite any shortfall in the required performance of the investment. The Government can protect its position by retaining the option of proceeding with the development with public funding rather than private funding.
- Simultaneously the Government needs to ensure that there are tax efficient investment vehicles for new build residential investment. The reform to REIT structures promised by the Government must deliver real benefits to investors in purpose built, new build private rental blocks. It is vital the structure facilitates new building.

STATE AID CONSIDERATIONS

DTZ recognises that provision of direct financial support to support the development of the institutionally funded model of new build rented homes development will raise State Aid issues. As part of its work for HCA under the PRSI, DTZ prepared a paper on this issue for discussion with the European Commission. Our understanding is that this was never discussed with the Commission.

There are four aspects of market failure that justify short term government financial support to establish a new investment model to support the development of purpose built new privately rented homes:

- Housing as a public good
- Barriers to entry preventing new market entrants
- Overcoming imperfect information
- Co-dependancy.

We briefly review these forms or market failure, since State Aid issues is an aspect of the debate that has not generally be discussed. More detail is available in the paper prepared for the HCA, which has been made available to the CLG with HCA's permission.

Housing as a Public Good

Though houses and flats in the UK are mainly privately owned and privately financed, the provision of good quality housing at prices and rents that are affordable is a central objective of UK government policy. Housing therefore has many of the characteristics of a 'public good'.

Thus the government seeks to ensure that the land use planning system encourages the private sector to deliver an appropriate quantity of new homes to meet the growing need for housing in the UK. Government policy also seeks to ensure that minimum standards are achieved in the delivery of new housing and in the maintenance of the existing housing stock.

Government also has a keen interest in the price of housing to UK households, though the levers it can apply to influence the price of housing in a market led system are limited.

Government already provides financial incentives to support the housebuilding sector through grants and loans; for example the Kickstart programme and the Get Britain Building programme.

Barriers to Entry Preventing New Market Entrants

The second form of market failure that the PRSI addresses is the substantial *barriers to entry* that exist for prospective institutional investors in the residential sector. Those institutional investors that have considered investing in the residential sector have encountered a series of inter-linked issues that work against their participation in the market. These barriers reflect the prevailing structural characteristics of the UK housing market.

- Institutional investors need to enter the sector in scale. Each investment asset class calls for an expert team who understand the dynamics of that investment class. If they are to invest in the residential sector institutions will require confidence as to the ability to build up scale over the medium term and also that the asset class will be capable of being traded.
- The predominant characteristics of the existing private rented sector is that it is dominated by small landlords. Thus there are no large portfolios of property to buy, and assembling a significant portfolio would take time and considerable effort. The resultant portfolio would very likely be diverse in terms of location, quality of stock, and tenant profile; it therefore present a challenge in terms of management and maintenance, which in turn would dilute prospective returns.
- Given these difficulties, securing a pipeline of newly built dwellings designed with long term renting in mind, is in principle more interesting to institutional investors. Until the downturn in the housing market, however, there was no prospect that developments for long term rent could deliver the level of land value generated by the traditional 'current trader' model of build and sell out into the open market. There was no interest among developers in building for rent, nor would institutions have been able to compete in the land market.
- As a result of the housing market boom, local authorities have been able to take advantage of rising values to secure the funding of community benefits, including social rented housing, through the negotiation of planning obligations agreed with developers. In effect such obligations reduce land value. Developments incorporating long term rented units would not generate the same land value as a conventional development for sale, and so could not afford to deliver the same level of public benefits, and are likely to have been seen as not complying with planning policy, that requires, for example, delivery of social and other sub-market housing.

Thus there are barriers to entry, which are largely connected with land ownership, the land use planning system as it operates in England, and existing models of new housing development. Addressing these barriers to entry is a job for government. Both central and local government can do much to reduce barriers to entry through being willing to use publicly owned land and through flexing the land use planning system in a way that support new build development for long term renting.

Overcoming Imperfect Information

The third form of market failure that holds back institutional investment in new build private rented accommodation arises from imperfect information. This has hampered efforts to encourage institutional investment in the UK in the past. Institutional investment in the residential sector in other nations within Europe has a long history. This means that the nature of the residential sector as an investment class is well understood. The level of return and risk is understood and performance data are available over a long period of time. The level of correlation with key variables such as inflation, earnings and with the performance of other asset classes is known, and therefore the role of residential investment in portfolio management is widely understood.

In contrast in the UK there is, compared to all other mainstream asset classes, a paucity of information about the performance of the residential investment sector. The performance of residential investment overseas is not seen as being any sure guide to performance in the UK since the role private rented sector varies considerably between nations for historic and cultural reasons, and the legislative and political framework within which the PRS operates differs greatly from country to country. The tax treatment of residential income also varies from nation to nation. In the absence of good performance data, investment in a new asset class is inevitably regarded as more risky and investors expect a higher return.

The Investment Property Databank (IPD) has done excellent work to develop performance indicators for the residential investment sector. However it is very heavily biased to existing built stock. There has been virtually no new purpose build rented accommodation built in the UK outside of the student residential sector.

Short term public sector support for institutional investment in the PRS can be justified to offset the risk premium that arises from imperfect information about the returns from institutional investment in the new build residential sector. The longer term aim must be to enable the development of sufficient investment volumes in the residential sector to the point that it will become possible for robust measures of performance to emerge. With certainty about the character of the investment returns available, the risk premium sought should reduce and the need for an element of public sector financial support will cease to be necessary.

Co-dependency

The fourth form of market failure that holds back institutional investment in the PRS arises from the existence of a form of network externality in relation to institutional investment in the UK residential sector. From a public good perspective it is evident that the market delivers fewer new homes than is desirable, and that this imposes widespread costs on the UK economy as a result of higher housing costs than other nations. Unlocking investment from institutional investors would contribute to raising housing output to a level that would be more economically efficient.

However a major barrier to unlocking that investment is the co-dependent nature of a range of different private and public sector organisations. If institutional investment in the UK residential sector is to occur the interests of numerous different parties need to be aligned and models of mutually beneficial interdependence need to be established. The key players in the process are:

- The institutions as investors; that is, those who provide finance, who need to earn an acceptable return, which will be judged against other investment opportunities
- Asset managers who take responsibility for stock selection, acquisition, disposal, capital works, rental policy, etc
- Managing agents responsible for day to day on the ground management lettings, tenant disputes, rent collection, etc
- Either developers who bring product to the asset managers; liaise with those asset managers regarding specification, and mobilise land and development finance
- Or contractors responsible for building to specification, if asset managers take the lead in procuring product
- Land owners
- Planning authorities.

When there are so many different partners who are key to the establishment of an effective model for delivery through the use of institutional funds invested in the residential, it is inevitable that it takes time to establish generally understood principles of the minimum returns different partners need, and to drive efficiencies through what is, in effect, a supply and management chain.

Inevitably there is a learning curve and in the initial stages therefore costs will be higher, and perceived risk will be higher. This provides a strong justification for public support, though this may well be achieved by the public sector taking the lead in 'market making'; that is, brokering deals between the different players, to establish the new delivery model that will unlock additional investment that will support new housing delivery in England and in due course in the UK. Direct financial support to the private sector may be unnecessary or very limited.

Co-dependency is a particular form of market failure, where, while there may be overall public benefits of achieving a certain change in the institutional framework or business model of a particular industry, and each participant will also benefit, the benefits to each individual party are not sufficient to incentivise them to take the lead in brokering a new business model. Without public sector leadership and investment the new model will never be established.

CONCLUSION

This paper demonstrates the complexity of unlocking institutional investment in new build privately rented property. We have highlighted the specific areas of market failure which justify some element of public sector intervention, to create the right environment for institutional investment and in particular to address the issue of co-dependency. DTZ believes the government has a central role in enabling the development of the institutionally funded build to rent model. It will not just 'emerge'.

Putting all this together is complex. It will take some time, but much of the ground work has already been undertaken through the Private Rented Sector Initiative established by the HCA three years ago, and only recently rejuvenated under the national housing strategy 'Laying the Foundations'. It will require investment. But the prize is worth it. Without unlocking institutional investment, the output of the residential development industry in England will not exceed 160,000 new homes pa this decade; and that is not enough to deal with the crisis that is upon us.

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