SPECIAL INTEREST PAPER

CENTRE FOR LONDON

CITY OF LONDON

Report prepared for the City of London Corporation
by Centre for London
Published January 2013

Institutional Investment in London's Market Rented Sector

City of London Economic Development
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Introduction

There is growing interest among policymakers in encouraging more institutional investment in the market rented sector (MRS). This is seen as a way of increasing the supply of new homes to meet growing demand, helping to raise standards, and fostering economic growth.

This paper assesses the potential of promoting greater institutional investment in the market rented sector in London. A number of recommendations are made as to how public and private sector players could work together to help secure this.

The paper is based on desk-based research, interviews with industry experts, and a roundtable hosted by the City of London in November 2012, which brought together developers, investors, local authority housing and planning professionals, policymakers and academic experts.

The first section of this paper reviews the case for promoting increased institutional investment in London's market rented sector. The second section analyses some of the challenges currently faced by potential investors in this sector. The final section sets out ways that key public and private sector players could work together to increase levels of institutional investment in London's market rented sector.

I. Promoting institutional investment – an emerging agenda

There are a number of good reasons to want to promote institutional investment in London's market rented sector (MRS).[1]

First, institutional investment could make an important contribution to increasing the supply of new homes. This is particularly relevant as London faces a severe housing shortage. A series of developments has contributed to the increased demand for accommodation in London. These include:

- A growing population, with London projected to grow by an additional 786,000 people by 2021;[2]
- Rising expectations and changing lifestyles (e.g. preference for larger homes, and a move to single person households);
- Increased international investment in London's residential market, which has become a 'safe investment' in turbulent economic times.[3]

At the same time, a countervailing series of pressures are severely restricting the supply of MRS housing. These include a constrained credit market, limiting the ability

[1]Throughout this paper we have used the term 'market rented sector' (MRS) rather than the more common 'private rented sector'(PRS) on the grounds that there are many landlords who let or might let properties at 'market rent' and who don't belong to the private sector as such, for example housing. associations and local authorities.
[2] The number of households in London is expected to increase by 36% by 2031 (CLG, from 2006 levels) The ONS sub-national population projections, 'Intelligence Update 2012', 23,

[3] M Ball, October 2012, Cluttons 'Renting in London: The coming boom', Occasional Paper Series,

of both developers and home-buyers to borrow; planning restrictions; and reduction of public subsidy for social or affordable rents. [4]

The result is that housing costs have risen very significantly relative to income in the capital. Though house prices nationwide have fallen substantially from their peak in 2006/7 (down 12%), the picture is very different in London. Despite falling real incomes, widespread economic struggle and tighter credit, prices are now three per cent higher on average than the 2006/7 peak. Although rents are still low relative to house prices, they are higher in London.[5] In September 2012, the average cost of renting a home in London was £1,273 per month. This figure marks a difference of 87.8% between renting a home in the capital and in the rest of the UK - the highest difference ever recorded.[6]

This in turn has had, or risks having, a series of negative consequences on London's housing situation. Homelessness and over-crowding for example have both risen in recent years. Trust for London states for example, that "*Housing costs are important in explaining why London has the highest poverty rates of all England's regions.*"[7] Even middle income households are having to make challenging compromises, with increasing housing costs leading to eroding living standards.[8] Large areas of London are becoming increasingly unaffordable for low and middle income households, exacerbating the gap between the more and the less affluent.

London's housing shortage and the rising cost of house prices are also likely to weaken London's economic competitiveness. As leading housing economist Professor Michael Ball observed:

> "*A reluctance to put up with rising housing costs and a lack of supply of good quality accommodation on the part of potential employees and the knock-on impact on salaries for firms will be key mechanisms through which jobs growth is constrained by London's intensifying housing shortage.*"[9]

It is important to acknowledge, of course, that we should not be looking to the market rented sector alone to meet London's housing shortage. A more rounded strategy will be needed to encourage the increased supply of market homes for sale, and socially subsidised affordable homes, and the Government and London's key players are looking to stimulate supply in both of these sectors. Securing greater institutional investment in the market rented sector, if it can be achieved, has the potential to make an important contribution.[10]

A second reason for wanting to encourage institutional investment in London's market rented sector is that it could help drive London's economic growth. There is evidence that housing construction supports more jobs than financial investment in

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[4] Department for Communities and Local Government (DCLG) Live Table 241, 2012,

[5] The Economist, August 2012,
[6] Homelet, 'Rental Index September 2012',
[7] Trust for London, 2011, 'London Poverty Profile',

[8] Resolution Foundation, November 2012, Commission on Living Standards, Final Report 'Gaining from Growth',
[9] M Ball, October 2012 – Op Cit.
[10] A Montague et al, August 2012, DCLG, 'Review of the Barriers to Institutional Investment in Private Rented Homes', paragraph 6, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/11586/2204242.pdf.

many other sectors of the economy, due to related activity. Every £1m of new housing output supports 12 additional jobs – seven directly and five indirectly - per year.[11] In addition, increasing the number of households renting rather than owning could help create a more flexible labour market, with workers able to move home and follow job opportunities.[12] In London, 34% of private tenants have lived in their home for less than one year, compared with three per cent of owner-occupiers and seven per cent of market renters.[13] Under-occupation is also much less common in London's market rented homes than in owner occupied homes - just six per cent compared with almost 40% of owner occupied homes.[14]

A third and final argument in favour of promoting more institutional investment in London's MRS considers how this could help raise standards.

As buying a home has become ever less affordable in London, so the size and the shape of London's market rented sector has grown. Government figures show that the market rented sector in the capital grew by 83% between 2000 and 2010, with around one in four now renting from the market.[15] That proportion is expected to increase to 37% by 2025.[16] Market renting is no longer a niche, short-term option of choice for students and young professionals. Middle income couples, families with children, and older people are also renting in much larger numbers than previously. There are, for instance, now more than one million families with children renting nationally, an increase of 86% in the last five years.[17] For example, the GLA estimates that *"20% of the growth in London's private rented sector over the last two years has come from families with children, and there are now more than 200,000 households with children living in the sector"*.[18]

However, there is widespread concern that London's market rented sector is failing to meet the needs and aspirations of many of its residents. A third of market rented sector homes in London fail to meet the Decent Homes Standard, compared with a quarter of London homes across all sectors and a fifth of housing association homes.[19] In addition, there appears to be significant unmet demand for longer tenancies, with short-term tenancies the norm.[20] A 2012 survey by Shelter found that 29 out of 30 letting agents told potential landlords that they would only offer a property on a six to twelve month tenancy, and 20 out of 34 letting agencies told potential tenants that they could not offer them a longer (three to five) year

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[11] A Montague et al, August 2012, paragraph 5 – Op Cit.
[12] A Montague et al, August 2012, paragraph 1 – Op Cit.
[13] DCLG, February 2011, 'English Housing Survey 2009/10', https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/6714/1851086.pdf.
[14] DCLG, February 2012, 'English Housing Survey 2010/11', https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/6735/2084179.pdf.
[15] Bleak Houses London Assembly, December 2011, 'Improving London's Private Rented Sector', https://www.london.gov.uk/sites/default/files/gla_migrate_files_destination/Bleak-Houses-Final-Report.pdf
[16] Mayor of London, December 2012, 'The Mayor's Housing Covenant: Making the private rented sector work for Londoners', https://www.london.gov.uk/sites/default/files/2012_09_28_mayors_housing_covenant_1.pdf
[17] DCLG, February 2012 – Op Cit.
[18] Mayor of London, December 2012, endnote 19, no time period given – Op Cit.
[19] GLA analysis of DCLG English Housing Survey Data 2010/1.1
[20] For example, in 2008, figures for Southwark20 show that 47% of private renters had lived at their current address for less than a year, compared to 10% for owner occupiers and 9% for those renting from the council or a housing association. Independent Commission on the Future of Council Housing in Southwark, 'Investing in Council Housing, Options for the Future', http://moderngov.southwark.gov.uk/documents/s32592/Appendix%201%20Investing%20in%20Council%20Housing.pdf

tenancy.[21] Yet the majority (66%) of market renters would like to have the option to stay in their tenancy longer-term if they could. In light of this, it is noteworthy that 44% of families with children say that they do not think of their private rented house as 'home' – perhaps because of the short-term nature of most MRS contracts.[22]

Here too though, it is important not to overstate the contribution that greater institutional investment in the MRS could make to London. The sector is currently almost entirely owned by landlords with small portfolios.[23] Two thirds of London landlords own fewer than five properties.[24] While small portfolio landlords have an important role in the market rented sector, it is reasonable to hope that greater institutional investment could lead to the development of new products that better meet the needs of many London renters, and might also help to improve standards sector-wide.

Against this background, it is not surprising that there is growing interest within central government, local government, housing charities and beyond, in encouraging greater institutional investment into the market rented sector. Most recently, the Government-commissioned Montague Review (August 2012) set out a series of recommendations with this purpose.[25] Through its 'Housing Stimulus Package', announced in September 2012, the Government has been quick to support most of these.[26]

II. Challenges and capital opportunities

Expanding the 'build to let' market in London is an important means to address both supply and price issues in the housing market. Investment for this expansion could come from the institutional sector, which is attracted to secure, predictable revenue-based returns. The Montague Review concluded that *"we are satisfied that the rented housing sector offers potential investment opportunities of interest to institutional investors."*

The Review found a 'good fit' between larger investors and the market rented sector. House price growth, rising rents, economies of scale, a good fit with liabilities and institutional balance sheets, all add to the business case for increased institutional activity in this sector. The recent decentralisation of local authorities' housing revenue accounts (HRA) has given them greater freedom to borrow and build, making them potential investors.[27] Similarly, reduced Government grants to

[21] Ibid.
[22] Shelter, September 2012 ,'A Better Deal: Towards more stable private renting'. Letting agent mystery shopping exercise (landlord scenario), May 2012. Two mystery shopping exercises on letting agents were conducted. In one scenario, Shelter contacted ten letting agents in Hackney, Leeds and Somerset as a landlord with a property to let out to find out about the fee structures on offer, tenancy lengths and rent increase advice letting agents offered their landlord clients. The 'landlord' spoke to ten letting agents in each area. See also the evidence in *Bleak Houses,* December 201 - Op Cit.
[23] DCLG, October 2011, 'Private Landlords Survey 2010', https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/7249/2010380.pdf.
[24] Mayor of London, December 2012 – Op Cit.
[25] A Montague et al, August 2012 – Op Cit.
[26] Number 10, September 2012, 'Plans to boost UK housebuilding, jobs and the economy', http://www.number10.gov.uk/news/plans-to-boost-uk-housebuilding-jobs-and-the-economy/
[27] For example, Southwark Council has headroom to borrow an additional £126 m under the HRA settlement on top of its current £451m housing debt portfolio and the Public Works Loan Board (PWLB) were offering rates of 3.03% for 30 year loans mid -2012. See 'Investing in Council Housing: Options for

housing associations has encouraged them to look more seriously at investing in the market or near market rented sector.

However, there are some significant barriers and perceptions to overcome before large scale institutional investment in the market rented sector will flow more freely, namely:

- Despite the 'bursting' of successive house price 'bubbles', rising house prices are now seen as natural and inevitable, creating a bias towards selling new homes rather than retaining them for rent.
- Expectations of Section 106, and the 2012 Community Infrastructure Levy-based 'planning gain', can reduce the viability of large rental schemes.
- Schemes with longer-term tenancies can limit the range of guaranteed exit options and negatively affect a development's value.
- The absence of private landlords with large portfolios often limits the scale, quality and consistency of the rental product. Institutional investors are looking for portfolios with at least 1,000 units of a relatively standardised, high quality produce, to ensure that operating efficiencies are achieved.
- The scale of past activity has yet to provide sufficient reliable information on financial returns across a defined asset class, where a minimum net yield of 5% is required.[28]
- There are doubts about the rental yields that can be achieved compared to other investment options.
- There are concerns about potential high management costs.
- The 'best consideration' requirement for public sector landowners tends to result in a preference for sale.
- There is a chronic lack of suitable land for development and Government initiatives such as the 'New Home Bonus' (providing an additional £8,000 per house) may not be enough to incentivise new development in the London context.
- Increasing the duration of tenancies could reduce churn and decrease 'liquidity', potentially making housing markets less flexible and responsive.

However, despite the challenges identified above, the coalescence of market trends and Government policy is making the build to let market much more viable in London and gives reasons for increased optimism:

Job creation in London will continue to drive demand for rented property. The extent of future jobs growth is a key driver of demand for housing in London,

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the future' - a report by the Independent Commission on the future of council housing in Southwark, October 2012. Furthermore, Richard Parker of PWC estimates that in aggregate, local authority HRA surpluses of £54bn could be generated over the next 30 years (Inside Housing, 10 October 2012).

[28] IPD data (as quoted in the Montague Review) reported that returns on residential property have totalled 9.6% on average over the last 10 years compared to returns of between 5.7% and 7.3% for commercial property. However, it is worth noting that historically, capital growth has been key to the residential returns.

especially in the market rented sector which is largely aimed at young professionals. The continued growth in employment that is projected for London should continue to guarantee an active and profitable rental market.

Restricted mortgage lending is here to stay. Much more restrictive lending is now hardwired into the mortgage market so there is unlikely to be a return to the past in the scale and extent of lending, especially to first-time buyers. This is likely to have a generational impact on access to owner occupied housing.

There is a clear target audience and geography for the market rented sector in London. While average house prices are the common metric for considering affordability, people tend to buy a house they can afford in terms of size and location. Therefore, aligning income and housing by segments (e.g. by quartile and decile) is key to understanding actual demand. Similarly, the comparative costs of rental and owner occupation (where this can be accessed) will affect the level of demand by sector. The prime target for market rented provision is young professionals with income but limited or no savings. To be affordable for this group, MRS developments need to offer rents at no more than 45% of net income while still supporting s.106 levies. This suggests a need for a spatial focus on locations outside the Central London area.

A cultural shift in home ownership perceptions may be underway. Following a long-term and rapid increase in house prices, nationally these have been declining and may continue to drift downwards. As historic levels of capital growth cannot be guaranteed, this may lead to reduced demand for owner occupied properties and increased demand for rental properties.

Investment appraisal models can evolve to reflect the nature of the market rented sector. Currently, yields on market rental schemes in London are around three to four per cent compared to the yields of (at least) five to six per cent sought by developers. To improve the yield, developers have highlighted that viability and investment appraisal models need to be further developed specifically for market rental schemes. This includes reviewing the approach to calculating the present value of long-term cash flows and the effects of restrictive covenants that may be required to ensure long-term market rented use rather than sale.

A growing list of schemes is helping to generate the necessary track record for a new asset class. The lack of a track record for large market rental schemes in London (most have been 100 to 200 unit developments) and a limited investment index means that some developers and investors will remain sceptical. However, there is a growing number of practical examples (see Annex) as well as a cohort of developers interested in making the model work in London. Increased demonstration effects could further help to mature the market.

Housing associations offer significant potential to expand the market rented sector. Housing associations are starting actively to embrace the potential of market rental provision. L&Q, London's largest housing association, recently announced that it is spending an initial £250m setting up a 1,000 home market rented sector portfolio, and is seeking backing from institutional investors to move the investment off its balance sheet in due course.[29] Large housing associations offer significant balance

[29] Currently managing 70,000 homes L&Q are targeting an internal annual return of 7.5% on investment and plan to offer investors 4% net return rising with inflation (Inside Housing, 25 October 2012).

sheets and competencies in development and housing management, as well as being trusted landlords.

The public sector in London can help increase land supply. This perennial problem across the UK is at its most extreme in London. Apart from 'building up' (there are currently 25 high rise residential projects in London and a further 78 with planning permission),[30] the very limited supply of land in London is a major constraint in bringing forward additional housing, including market rented housing. This is an area where the public sector could play an important role in identifying and bringing forward sites in London, as well as exploring whether the public sector would take any equity stakes in developments in return for land contributions and relaxing best price obligations at sale.

Recent Government initiatives can further support increased institutional investment. Following the Montague Review, the Government announced in September 2012 a £200m market rented sector fund and £10bn of state-backed guarantees for housing, which is triggering interest from housing providers. Hyde Group, one of the largest social housing landlords in London, is aiming to access these new Government funds and is exploring setting up a new Real Estate Investment Trust (REIT) to free-up additional investment for social housing. The guarantee scheme could leverage L&Q's £250m market rent initiative to be worth up to £1bn. Furthermore, in November 2012, the Government announced a consultation on measures to increase the proportion of local authority pension fund assets that can be invested in housing and other infrastructure.[31]

There is potential for the more ambitious London Boroughs to explore changes to the planning system. Currently the planning system is relatively 'tenure blind' but there could be a number of ways of assisting the supply of market rental houses. A key issue is whether planning can help to ensure long-term rental use and prevent an early exit to owner occupation. Foregoing s.106 contributions on market rental developments could help to reduce development costs (it was initially used to increase the provision of student accommodation).

III. Next steps - how the capital's key players could work together to promote institutional investment in London's market rented sector

There are now long-term opportunities for at-scale increases in building to let in London. Some housing associations and private developers have and are developing a track record in smaller scale projects in London and elsewhere. While significant interest from institutional investors is yet to appear, there are a number of positive signals suggesting the market is poised to develop, and there is potential for new business models to emerge.

[30] Knight Frank, 2012, 'Tall Towers 2012: London's high-rise residential developments',

[31] The Local Government Pension Scheme England and Wales is administered by 89 separate local funds and hold assets worth £150bn. To ensure asset diversification, fund managers are currently limited to investing a maximum of 15% in partnership vehicles, which include many types of housing and infrastructure investments. The Government is consulting on proposals to increase this limit to 30% which could potentially release up to £22bn of additional funds.

Many commentators are forecasting a continuing growth in market rental provision in London (subject to the nature of the economic recovery)[32] as well as increases in rents, with the potential for capital growth in the right locations.

> *"Rents are broadly influenced by the same factors as house prices and one of the main drivers of rents is the rate of change of earnings. Yet, there are good reasons to expect rents in London to rise at a somewhat faster trend rate than house prices. The forecast here is for rents to rise at 5% yearly with somewhat larger increases over the next couple of years as the market adjusts to new realities."* [33]

Following the points set out in this paper, this section sets out a number of ways that the Montague Review's agenda could be furthered in London, and increased institutional investment in the market rented sector encouraged.

Key players identified include the Homes for London Board, the GLA Housing Investment Group, the London Pension Fund Authority (LPFA), and private sector developers and investors.

1. **Create large scale MRS opportunity areas in London.** The Montague Review suggested creating a new market rented 'Use Class', to ensure new homes remained in the rental sector for a fixed period of years. Examples include having fixed terms of 10 to 21 years or waiving affordable housing requirements in rental schemes. The GLA and interested London Boroughs could therefore identify a selection of sites and, using flexibilities under the localism agenda, aim to relax affordable housing requirements in a trade-off to secure more market rented provision with longer-term tenancies. There is also potential to explore US models, where all the property on a site is identical and privately rented but a proportion (say 20 to 25%), offer discounted or more affordable rents. An increasing range of schemes in London will help to provide a stronger evidence base for a distinct asset class.

- **Development spaces of adequate scale outside the Central London area could be identified and used as pilots for large scale MRS developments, working closely with private developers and housing associations.**

2. **Leverage London's pension pot.** The London Pension Fund Authority (LPFA) could become more involved in the MRS in London by becoming an investor in a fund, for example by engaging with a development vehicle or becoming an end-buyer.[34] Currently, the LPFA invests £300m of its £4.2bn pension portfolio in property and infrastructure (some overseas). The average annual return of the portfolio has been poor - 2% over five years and 4.1% over 10 years. Comparatively, private rental yields could at least match and perhaps exceed this longer-term performance. This is timely as the Government is currently consulting on increasing the proportion of local authority pension funds that can be invested in housing and infrastructure.[35]

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[32] Market rental is forecast to increase to 37% in London under some scenarios in C Whitehead, P Williams et al, June 2012, 'Housing in Transition: Understanding the dynamics of tenure change', Cambridge Centre for Housing and Planning Research.

[33] M Ball, October 2012 – Op Cit.

[34] See Future Homes Commission (2012) for discussions of the opportunities from pooled and collective pensions (across local authority schemes).

[35] DCLG, November 2012, 'Local Government Pension Scheme: Investment in partnerships'. Consultation period ended 14 December 2012.

- **It may be worthwhile to carry out an investment feasibility study to examine the potential for LPFA funds to invest directly in large scale MRS pilots in London.**

3. **Help raise standards in MRS products.** High quality market rental products are required to ensure desired capital values successfully address market need, to give a strong brand message and develop a consistent asset class. Clear design and quality guidelines for developments in London would help inform potential customers. There appears to be universal support from developers, asset managers, investors and the public sector for achieving high quality standards.

- **Building on existing codes, MRS design guidelines could be produced jointly with the private sector and used in pilot MRS areas.**

4. **Use the 'Government Guarantee Scheme' where possible.** In the short-term, there is scope for drawing down the Government guarantee to trigger some larger scale developments and funds. For example, L&Q is currently considering this approach. However, longer-term investment decisions need to be based on real development risks, so any *de facto* subsidy is relatively short-term.

- **The Government Guarantee Scheme could be used by large housing associations (for example), to ensure the completion of a successful MRS development at scale in the pilot areas.**

5. **Blend market and affordable rent provision.** For major sites in London, and with a move to affordable rents, there may be potential for housing associations to work actively with local authorities to blend market and social rental provision, particularly for housing estates in need of significant investment to improve standards and possibly increase density. Local authorities could explore ways to bring their housing revenue account (HRA) headroom to support the investment costs and to develop new delivery models.

- **One or more of the pilot developments could involve an innovative London Borough bringing additional borrowing from its HRA headroom to include 'affordable' social rental provision within the development.**

6. **Stimulate more innovative public and private sector working.** The broad localism agenda provides a mandate for local authorities to act innovatively to meet local needs and to use local strengths. This may involve exploring risk-sharing (e.g. by taking an equity stake in a MRS development in return for bringing land to the deal), looking at how planning restrictions can ensure long-term tenancies, and relaxing the best value requirement around publicly owned land.

- **Institutional investors, developers, local authorities and housing associations could choose to meet periodically to share sector understanding and to increase the potential deal flow.**

7. **Establish greater coordination across London with key MRS players.** The Montague Review suggested introducing targets to drive public sector land release for market rented housing and an increased role for central government, the GLA and local authority partnerships. For example, a London focus on MRS may be well served by greater coordination between the key players in London to help take this forward. If successful, the models could provide a basis for nationwide practice.

- **The London Boroughs could consider jointly coordinating the key London MRS players to support the pilot schemes.**

Annex – examples of institutional investment models in practice

As the Montague Review and others have highlighted, there are examples of innovative partnerships between local authorities, developers and institutional investors:

Manchester City Council
Manchester Council, Greater Manchester Pension Fund and the Homes and Communities Agency have formed a partnership to build 240 homes. The Council will put in land while the pension fund will provide finance for the development. The Homes and Communities Agency is also putting in one site. This will reduce for risk for the developer, which is yet to be appointed, allowing homes to be let or sold at below market rate. The council hopes the homes will be sold for 20% less than market rate. The council will take an equity stake in the homes, and the partnership will generate revenue to reinvest from rents and sales.

East Village, Stratford
Stratford's Athletes' Village has been bought by a partnership of Housing associations, developers and investors who plan to rent rather than sell the great majority of the development's 2,800 new homes, 1,379 will be affordable. Later phases will see a great number of homes built for sale, but the plan is to retain a proportion of these as rental properties.

Fizzy Living
Subsidiary of Thames Valley Housing Association that will build high quality homes to let to young professionals at reasonable rents and with the option of longer tenancies.

Grainger's Build to Rent
Minimum 100 unit developments with high standards of management strategically sited with year-long, renewable tenancies and a target rent of 30 to 40% of average local incomes.

Terrace Hill Group/Allsop Residential Investment Management
A partnership between the large private landlord and Southwark Council that balanced tenure struck a balance between rent levels, nomination rights and deposits.

Argent King's Cross
Significant proportion of new build development held for private rental in a joint venture with an institutional investor.

Broadway
Broadway is a charitable organisation in London that focuses on homelessness. It provides a range of services to help people get accommodation, improve their physical health, gain training and employment, and live independent lives. In 2005 Broadway launched 'Real Lettings', a property fund that offers affordable accommodation in the MRS for former homeless people who do not qualify for social housing but are ready to maintain a tenancy.

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