MAKING SENSE OF LARGE-SCALE RESIDENTIAL INVESTMENT.

A report by Professor Michael Ball, Henley Business School, University of Reading from Get Living London.
Making sense of large-scale residential investment.

Residential property is the largest real estate asset class by value and yet by comparison to commercial property it has comparatively low institutional investment interest — why? This is the question we commissioned Professor Michael Ball of Henley Business School, University of Reading, to investigate further.

The increasing demand for residential property driven by increasing population and low levels of house building, is creating major opportunities for institutional investors. It is against this backdrop that we have launched Get Living London, a new residential owner and rental management company. Professor Ball’s report has clearly identified the considerable opportunities for institutional investors in large-scale private rental schemes.

Get Living London is launching its first owner-managed homes at East Village, London’s newest neighbourhood and the first legacy neighbourhood from the 2012 London Olympic and Paralympic Games.

By providing a long-term commitment to a new neighbourhood with a focus on professional management and providing flexible and consumer-centric rental agreements, we are offering a new approach to rental in London. This proposition, coupled with the underlying fundamentals outlined in this report, give us great confidence that Get Living London will be a true innovator in a sector that is ripe for growth.

We hope that you enjoy this report and we look forward to publishing further research into this interesting area of the property sector.

Derek Gorman.
Chief Executive, Get Living London.
Making sense of large-scale residential investment. Although it is by far the largest asset class in the UK, it is currently a small one in terms of large institutional holdings. The purpose of this report is to elaborate on the reasons why there is a strong case for institutions to increase their asset allocation to residential investment. Strategies should emphasise long-term holdings rather than trading options.

1. UK residential provides good returns over the long-term and relatively limited volatility.
2. UK residential is likely to provide particularly strong returns in the coming years because of the scale of housing shortages in the major cities, particularly London and its hinterland.
3. Much growth in housing demand in London is associated with an expanding workforce of young, relatively affluent professionals whose housing demand is particularly suited to the sectors of the housing market where large-scale investors have a competitive edge.
4. The long-run demand for residential property is much greater than for commercial housing demand rises with incomes and wealth, whereas firms are cost sensitive and therefore are always interested in lowering rent costs where feasible.
5. House prices and rents are closely linked over the long-term but rents vary less than house prices during cycles.
6. Residential investment has favourable income-matching and inflation hedging properties for institutional investors.
7. On the supply-side, long run shortages in residential are much greater than in commercial, because of more favourable planning views on job creation and development in inner city locations. The severe constraints on suburban residential expansion lead to less vacancy risk throughout the housing stock and upward pressure on rents.
8. Over housing market cycles, rents fluctuate far less than house prices meaning that rental income yields have particularly low volatility.
9. The long-run price of residential in the UK is strongly upwards, which cannot be said for commercial property. UK house prices in real terms have been rising by 3% annually and can be expected to rise further in the future.
10. Over the long-term capital gain and rental income returns converge because property prices are the present values of expected future rent streams. As the distinction between income and capital value growth becomes increasingly artificial over the long-term, it is a mistake to focus simply on current rental yields when making an investment decision.
11. The service offer in residential is different from that in commercial real estate, reflecting much higher tenant turnover and greater property management and engagement. However, the difference is priced into rents when residential is appropriately managed.
12. Large-scale residential investments benefit from large number effects, with low defaults and regular incomes because the idiosyncrasies of individual lettings factor out when dealing with many tenants. This contrasts with commercial investment where relationships with only a handful of key tenants are the norm.
13. Particular segments of the residential assets market benefit from scale economies and these types of asset are most suitable for large scale investors – e.g. student housing, new build apartment blocks, ‘new villages’, etc.
14. Large-scale investors should be able to achieve purchase price discounts from housing developers, because developers face significantly higher transactions costs selling their residential properties individually rather than in bulk.
15. Development risk should not be confused with asset holding risk. Residential is a low-risk investment for ‘successful’ schemes (i.e. post-completion). Build-to-let encompasses development risk, whereas ‘off-the-shelf’ purchases do not.
16. The UK needs many more build-to-let large scale schemes for large-scale residential investment to become a major sphere of investment. The planning system needs to be more accommodating to such schemes and to recognise the significance of development risk and the need for viable returns.
17. The management of residential developments may best be achieved through use of professional residential management teams.
18. Depreciation is typically less in residential than in commercial and the costs of refurbishment are also lower.
19. Residential investors are typically tax disadvantaged in relation to owner occupiers, which can affect the relative pricing of residential property by investors in relation to that of home owners. However, those tax advantages typically accrue to home owners over the long-term and, therefore, have less effect on pricing in the market sectors targeted by large-scale investors.
Making sense of large-scale residential investment.

Introduction

Residential is a distinctive real estate asset class in the UK by far, as it is in most other countries. The private rented sector alone was worth around £1 trillion in 2011 with an estimated 4.7 million properties, 17% of the nation’s housing stock. Yet, institutional engagement is only a tiny fraction of that. This can be seen in the coverage of IPD UK residential index, which monitors most large-scale investors’ holdings. It encompasses only around £2bn worth of properties, or 0.18% of the total private rented sector.

Large-scale direct institutional engagement in the mainstream private rented sector overall is limited to a handful of enterprises. Several of them have quite significant holdings in high priced locations, often for historical reasons, so that even the measured value can give a misleading impression of the number of dwellings actually owned.

Numerically, large investors are thin on the ground and, although international comparative data are quite poor, the evidence indicates that they are under-represented in the UK compared to a number of other countries. Small-scale landlords predominate across the world. Yet, even a minority share of such a large asset class as residential still represents a major investment opportunity. Large-scale investment, furthermore, offers considerable benefits in terms of the functioning of the private rented sector, because the international evidence shows that it provides distinctive products that many consumers value.

There are some signs of greater interest, with recent purchases of some residential assets by large institutional investors, such as the Prudential and Grainger/APG, alongside the continued holding of properties by traditional owners. But there remains far more discussion than action. In contrast, smaller UK investors have been expanding their portfolios. There has also been a surge of overseas small-scale investor interest in recent years, especially in prime London locations, a part of which adds to rental supply.

Most investors buy, at most, a handful of properties in any given year. However, interest in large-scale residential schemes has been growing alongside greater institutional interest. It will be argued here that the case for investing in UK residential seems strong but there are some issues that suggest that large-scale, ready-built developments operated by professional management teams may provide some of the best opportunities for large-scale investors. This type of investment is common in the US and in some European cities but scarce in the UK. This cannot be simply put down to investor reluctance because there is also a lack of readily available investment opportunities of this sort.

The purpose of this report is to outline the benefits of investing in the private rented sector as a whole and to highlight some potential issues in relation to it. The focus is on medium-term ’structural’ issues: because current circumstances are strongly influenced by ever-changing events, and on the basis that large-scale residential investment is better treated as a long-term rather than a trading investment.

The following sections examine:

• The reasons why rental demand is growing fast and investment opportunities are improving.
• Highlight London as the core rental market in the UK, with the greatest demand pressures.
• Examine investment returns and the dynamics between income and capital returns.
• Identify why rents fluctuate less than house prices over time and the implications for the investment appraisal of residential property.
• Suggest that residential values over the long term are relatively strong in relation to those of other real estate assets.
• Consider the significance of depreciation in residential and commercial real estate.
• Highlight the distortions to the own/rent choice generated by taxation and the consequences for residential investment strategies.
• Examine the implications of various residential investment options.
• Identify the importance of property management in investment strategies.

“...interest in large-scale residential schemes has been growing alongside greater institutional interest.”
THE FUNDAMENTAL REASON FOR INVESTMENT: BOOMING RENTAL DEMAND.

STRONG TREND - HOUSE PRICE AND RENTAL GROWTH

The UK has one of the worst housing shortages amongst the world’s advanced economies, because supply has been growing slowly while the population has been expanding rapidly and living standards have been rising.

The population of England and Wales grew by 7% in the decade to 2011, according to Census data. That was the largest 10 yearly increase since records started in 1801. London, which has a particularly large private rented sector, experienced the fastest growth, with a 12% increase in its population.

Furthermore, many households will again experience rising living standards with economic recovery after several years of squeezed earnings. With renewed growth, they will be willing to pay more for accommodation, particularly in relatively affluent areas like London and South East England.

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LOW VACANCIES.

UK suffered neither substantial defaults nor high vacancy rates in the housing market in the recent downturn, in marked contrast to experience in the USA and that in some other European countries. In part, this is due to the low interest rate policy and lender forbearance programmes adopted by the UK monetary authorities in common with others in Europe and the USA. However, it also indicates the extent of housing shortages within the UK and the strength of demand in its private rented sector, which has been the only part of the housing market that has been consistently growing in size over the past decade.

DEBT BURDENS ARE GRADUALLY EASING.

The relatively high rate of general price inflation in recent years has also had the indirect effect of helping to erode the real value of the outstanding mortgage debt built up in the boom years. This has lessened the risk that the housing market may be derailed at some time in the future by debt overhang when interest rates once again move up from their current low levels.

CYCLICAL CONDITIONS HAVE TURNED IN FAVOUR OF INVESTMENT

Figure 1 shows that there are significant long-cycles in real house prices, alongside a positive trend. Those cycles are variable and hard to predict. Nominal prices, which include general price inflation, do not vary as much and, so, real change occurs when house prices either lead or lag behind general inflation.

In recent years, there has been significant readjustment in real house prices nationally, as can be seen in Figure 2. The end of the downturn is forecast to occur this year, with stronger pricing in subsequent years, though with a weak economy the precise timing of stronger national market conditions remain uncertain. However, nationally the point in the house price cycle currently remains attractive from an investment point of view; while London’s price cycle experienced only a relatively short downswinging at the depth of the recession.

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FIGURE 1. Real UK House Price Changes over the Long-term.

FIGURE 2. UK House Price to Earnings Ratio over the Long-term.
Making sense of large-scale residential investment. cont...

**The Fundamental Reason for Investment: Booming Rental Demand.**

There is uncertainty and debate over whether the financial crisis has led to a permanent downward shift in owner occupied demand or, rather, whether it is mainly exhibiting the downside of a severe property cycle, compounded by a financial crisis. Scepticism over major long-term changes in tenure shares in the UK is probably in order, because property ownership in a country with such strong house price trends is at least as advantageous for owner occupiers as it is investors.

However, in terms of recovery, the UK owner occupied market remains severely constrained by a shortage of mortgage finance. This may have long-lasting features. Higher capital requirements for lenders, far less competition in the mortgage market, and much reduced access to capital markets will continue to stymie mortgage expansion for a long time to come. Affordability in parts of the country, such as London, continues to remain a problem that is only likely to worsen, making the first step into owner occupation ever harder.

Much publicised recent government schemes to encourage first-time buyers are unlikely to have much effect on the problems of the owner occupied housing market. For example, details of the mortgage guarantee scheme, targeted to come into effect in January, 2014, remain unknown and it may well turn out to be of limited effectiveness, given the possible costs of using the scheme and the overall constraints on mortgage expansion. The programme is almost certainly only going to be a temporary one in any case. Yet, more importantly, these policies do not address the fundamental problems of the mortgage market, mentioned above, nor housing affordability, with house-building stuck at low levels.

The prospect of a major downturn in private rented demand as a result of a strong revival in owner occupation consequently remains slight. This is particularly the case in London, which is likely to become increasingly a renters’ city, because of its affordability problems.

**Constraints to Moving into Owner Occupation Remain High.**

The private rented sector has increasingly become a right-of-passage for those eventually aiming to enter owner occupation. In the early 1990s, less than a third of first-time buyers were previously renters; now around two-thirds are. Many people are becoming homeowners much later in life than in earlier generations and wanting good quality, privately rented property instead.

This change has partly been secular because housing affordability has worsened over time, making the step into homeownership more difficult to make. However, there have also been cyclical effects associated with the house price boom up to 2007 and the subsequent financial crisis and weak economy. First-time buyer demand has picked up from its troughs in 2008/9 but is still far below pre-crisis levels and is likely to remain that way.

**Nationally, trend growth in house prices over the past three decades have been rising at almost 3% a year in real terms...**
London is the centre of residential investment in Britain. It has a significantly higher private rental share than the rest of the country, at a quarter of the city’s housing stock. The expansion of the private rented sector has been exceptionally fast over the past decade and expansion is forecast to continue apace.7 Slightly less than half the stock is in owner occupation, with a particularly low share of households with mortgages.8

Several factors encourage renting instead of ownership. The first is the high cost of housing, which makes it difficult to buy. London has the nation’s highest house prices. Furthermore, prices have been moving up relative to those in the rest of the UK over the past decade and people struggle to become first-time buyers in the current economic and financial climate.

As important housing costs, however, are the characteristics of the city’s economy and labour market. These are high concentrations of younger, highly-skilled, more mobile people. The surge in jobs over the past decade has slowed somewhat in recent years but shows no sign of abating and will accelerate again as the economy picks up. London’s labour market is also associated with high levels of international migration. All these factors combine to keep raising housing demand in general and focus it on the private rented sector.

The sheer scale of the London market also makes it the most liquid in the UK from an investment point of view. It towers above the rest of a small range of British towns with its stock of relatively new, purpose-built blocks of flats.

Shortages in London keep vacancies low. Outside of expensive central London, void periods were only running at just over two weeks in 2012 and were substantially lower than in the rest of the country, according to ARLA. Research has also shown that vacancy rates in residential are typically lower than in commercial property.9

A significant problem for investors is a relative scarcity of new, large-scale developments. London, like elsewhere, is afflicted by the UK’s classic mix of tight planning and infrastructure constraints that limit opportunities to build high quality, viable new urban and suburban communities.

Over the past five years, rent increases have been far stronger in London than in the rest of the country, where they have generally failed to keep up with inflation. Rents in the capital grew by 8% in the year up to March 2013, according to the LSL Property Services buy-to-let index.10

However, differences in house price movements mean that rental yields are more closely aligned across the country than rental growth information alone would suggest (Table 1). Data on rental yields now indicate higher returns than at the peak of the housing market boom in the mid-2000s and yields are moving back towards the levels seen in the late 1990s, prior to the prolonged house price boom of the 2000s.

IPD data reports lower rental returns than others but this may reflect the nature of the historic stock held by the institutions reporting information to it. The IPD rental return of 2% in 2012, for example, contrasts with that of LSL, based on agency data for many small-scale private landlords. There are differences of definition and calculation between the measures but the weight of evidence suggests that market-based returns are closer to the higher reported figures. (Overall returns, including capital growth, bring the IPD measure closer to the others.)

Longer-term IPD data shows total residential returns significantly outperforming commercial property over a 10 year period to end 2012, being over a third higher.11 Historic analysis shows similar long-run results over a 30 year period, combined with less volatility in returns and diversification benefits.12

<table>
<thead>
<tr>
<th>Location</th>
<th>Rental Yield (%)</th>
</tr>
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<tbody>
<tr>
<td>London (Central)</td>
<td>7.0%</td>
</tr>
<tr>
<td>London (Outer)</td>
<td>6.1%</td>
</tr>
<tr>
<td>North West</td>
<td>6.8%</td>
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<tr>
<td>South West</td>
<td>6.3%</td>
</tr>
<tr>
<td>West Midlands</td>
<td>6.2%</td>
</tr>
</tbody>
</table>

Source: Paragon.

12 M. Ball, Large-scale investor opportunities in multi-family property, or various Investment Property Forum Research Findings, 2007. BPF Act
Rental Income and Capital Growth: A Questionable Dichotomy.

The division between rental income and capital growth returns from real estate asset holdings is a classic distinction within investment analysis and appraisal. However, this accounting convention has led to potential misinterpretation of the nature of cash flows from residential investment.

Rental Income

It is commonly argued that a disincentive to institutional investment in residential is that most of the return is in ‘capital growth’, whereas what institutions are looking for is income to provide cash to match future liabilities. The frequently mistaken implication made is that the return from capital growth is lumpy in cash terms and can only be realized upon sale of residential property. However, there is a clear link between capital and rental growth in residential, because rents change on a frequent basis to reflect prevailing market conditions, either with tenant churn or through revisions to current tenancy terms. While, undoubtedly, there is a more clearly observable division between income and capital returns in commercial property, where long leases at fixed rents with limited upward only reviews are common, this is not usually the case in residential. (The fixed terms for commercial leases have, in any case, been falling in length, so that institutions are already experiencing a changing environment in this regard.)

The accounting convention of measuring rental yields at current market prices may contribute to the belief in a lack of cash flow in residential. If, for example, rental yields were a low 2% at the beginning of a year and rents and house prices then both doubled by year end, measured rental yield would still remain the same low 2% figure at year end values. Yet, cash flow is now twice as high as it was a year earlier, rather than locked up in spectacular but unrealisable 100% capital growth. Investment appraisals that fix residential rents at current values in order to be cautious but assume residential prices will rise by 5% annually are in danger of imposing conflicting assumptions within the same appraisal calculation.

Prices and Rents.

Do Owner Occupiers Determine Prices?

There is a frequently held belief that house prices are determined by owner occupiers alone, because they represent the majority of purchasers, and not by renters and investors. This then puts the latter at a pricing disadvantage.

This is highly unlikely to be the case. Rather it is the simultaneous interaction of total demand and supply in a housing market area that determines market clearing prices, which are then subsequently reflected in house prices and rents. With 31% of the UK’s private rented sector is clearly a significant element of total demand.

So, renters and the investors that own their properties are not at some innate disadvantage. This is particularly the case in certain sub-markets. For example, investors often outbid home owners for accommodation in the more expensive central parts of London housing market, where shares of private renting are particularly high. This situation has been exacerbated in recent years by the surge of overseas investor interest in the London housing market.

Investment Returns and Vacant Possession Valuations

An issue of concern to investors is that vacant possession valuations are often assessed as being higher than the investment value of rental income from properties. This difference is at variance with the analysis above on the long-term congruence between rents and house prices. It suggests that there needs to be a rethink about the ways in which valuations are undertaken.

Part of the problem relates to the assessment of market prices and rents. Current house prices are affected by views on further prices. If purchasers expect prices to rise in the future, they will be willing to bid more for a property than otherwise. As noted earlier, trend housing price growth is strongly positive in the UK, so such a supposition is well founded. In contrast, rent revenues are typically assessed at current values rather than assumed to rise in tandem with house prices on a trend basis. But the danger is that by doing valuations in this way conflicting assumptions are being employed in open market vs. investment value comparisons; ones which inadvertently bias against the investment option.

Another issue arises specifically with large-scale investment. The open value assumption made there is that values are the same if only one dwelling is put on the market as if all of them were simultaneously. So, the open market valuation of project then is a simple matter of multiplying the assessed unit price by the number of dwellings in the scheme. Yet, in practice, to put all of the properties on the market at the same time might easily generate a glut and push prices lower. Furthermore, it could take a matter of years to sell off the properties, which itself generates additional costs. Open market valuations should reflect this factor. This could be done by discounting an assumed future phased sales programme.

13 E.g. Montague Report. Review of the barriers to institutional investment in private rented houses. DCLG, August 2012, para 25 & 34 & comments in Allowing house residential investment
Understanding investor appetite and opportunities. Berthon Longton Partners

15
The complications of housing market cycles.

In the years prior to 2007, UK house prices shot ahead of rents and this helped to give the impression that rents always trail behind. But this is not always true. A more reasonable assumption is that rents and house prices trend in tandem, because they are both driven by the same underlying economic circumstances.

• There is not a fixed ratio between rents and incomes, but earnings growth nonetheless is a reasonable guide to rental change.
• The existence of housing market cycles does not negate the long-term growth of rental investment cash flows in the UK context.
• There are no comparable data on longer-term rents, with which to examine their movement relative to prices. However, a simple housing economics model can help to understand the differences in behaviour of rents and house prices over the course of a housing market cycle.

From an investor’s point of view, these cyclical issues highlight both the interconnectedness between residential property values and rents and also the need to base decisions on the expected future context rather than the recent past.

Moreover, the arguments above would suggest that the current stage of the housing market cycle is favourable from an investor point of view, because the dynamics of rental growth have been improving relative to house prices in many parts of the market, contrary to experience throughout most of the 2000s. In contrast to a decade ago, rents are set to rise at a relatively fast rate as housing demand recovers and strengthens. It may therefore be a good time to invest in residential property in the UK, providing, of course, that rents are set to rise at a relatively fast rate, with which to examine their movement relative to prices. However, a simple housing economics model can help to understand the differences in behaviour of rents and house prices over the course of a housing market cycle.

The existence of cycles and their variability is unsurprising as they are caused by detailed variations in demand and supply, the long lags that exist in this type of market, especially on the supply-side, and potential ‘bubble’ and ‘bust’ periods.

In general, rents fluctuate far less than house prices over the cycle. In part, this is because rents tend to be ‘sticky’. Rents contracts influence the but, in addition, landlords tend to be reluctant to raise rents for sitting tenants in rising markets and unwilling to cut them in weaker market conditions. There is also a fundamental difference between owning and renting in that purchasers can borrow mortgages and use their own wealth to acquire their accommodation, whereas renters are constrained by their own short-term resources, notably earnings.

A purchaser’s willingness-to-pay is influenced by their expectations of future prices (and rents), current housing equity, their compelling ability to borrow and the cost of borrowing.

Major UK house price cycles are long and variable in duration, as can be seen in Figure 1. The trough-to-trough time span from the early 1980s to the mid-1990s was around 15 years, while the most recent trough-to-trough is likely to be 20 years, assuming the national market is currently bottoming out. These cycles are long, but within there are also shorter, smaller fluctuations. Typically, there are at least two years of falling real prices than of rising ones and actual house prices fluctuate less than real ones, because general price inflation erodes the value of properties.

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Price expectations may be wrong, which in aggregate can lead to price overshooting in either the upward (bullish) or the downward direction (busts) at particular phases of the cycle.

In this framework, in rising markets house prices are likely to move ahead of rents as purchasers’ make higher bids to secure houses in expectation of future house price rises. They borrow and use the rising value of existing home equity to fund purchases. In downturns, conversely, purchasers (and landlords) experience capital losses. Home equity falls, loans are hard to come by, defaults may rise and prices weaken.

This process helps to explain the greater volatility of prices over rents, as the latter are anchored to earnings. There will be a tendency for rental yields to decline in upswings as house prices rise shoot ahead of rental growth; while investors’ capital gain returns grow slow-er-evolv-ingly. The converse takes place in weaker markets.

However, to complicate matters, there is unlikely to be a fixed relationship between income and rents. This is because people can devote more or less income to housing costs and are also able to alter the amount of accommodation they consume. For example, a prospective tenant may respond to higher rents by accepting that a rising share of their income is going to be spent on housing or, alternatively, opt for a cheaper opportunity to offset rising rents, such as a smaller flat, sharing, or moving to a lower priced location.

There is also an additional effect causing divergences between house price and rental growth over the housing market cycle: the greater propensity of investors to buy-to-let in ‘boom’ times in the expectation of capital gains. The more investor purchases grow into boom periods, the lower are rent increases likely to be at such times, because rental supply is expanding relatively rapidly due to these investments. This supply boost will further temporarily squeeze rental yields. Such an effect occurred in the UK during the ‘buy-to-let’ boom in the years prior to 2007.

During downturns, the opposite dynamic occurs with house prices declining faster than rents; while, in the early stages of recovery, rents may well rise at a faster rate than prices as potential owners may delay purchase for fear of further price falls and credit conditions may still be tight. Similar fears will affect rental supply. When house prices are weak, investors may fear capital losses and so hold off of the market, leading to new rental supply temporarily drying up and putting pressure on rents when demand remains strong.

International demand adds a further dimension to decisions in the dynamics of house prices and rents, particularly as parts of the London market. The drivers of this investment partly relate to the UK economy but are wider world-wide and to specific circumstances within their own national economies.

The overall outcome is that the next cycle is far more muted than the house price cycle and that rent yields vary over the cycle as well. From an investor’s point of view, rental yields when measured against current house prices will probably be at their lowest at the peak of price upswings and at their highest during the early phases of recovery.

The existence of cycles does not negate the general point about the trend relationship between market rents and house prices but rather indicates that it is a missing target combining trend and cyclical factors.*

* In part, the relationship is influenced by variations in 1) interest rates and the target rates of return used in discounting rental streams to present values; and 2) tax policies affecting housing. For the purpose of this analysis it is easiest to assume that they are constants.

BOX 1: THE RELATIVE BEHAVIOUR OF HOUSE PRICES AND RENTS OVER HOUSING MARKET CYCLES.
LONG-RUN TRENDS POINT TO RESIDENTIAL VALUES BEING RELATIVELY STRONG IN RELATION TO OTHER REAL ESTATE ASSETS.

Earlier when considering long-run UK house price growth emphasis was put on demographics and rising living standards in the face of supply-side constraints. It is also of interest to hypothesise about how they are likely to perform relative to other property assets. There are two key differences in behaviour between residential and commercial markets that suggest a potential greater strength of future residential values. One concerns demand and the other regulation.

On the demand side, the demographic picture in the UK has already been highlighted with rises in population and households and resultant shortages of accommodation that are going to persist. But there is another general point to be made about housing consumption. Over time, with rising incomes, people want more living space per person and better quality/location accommodation. In technical terms, the income elasticity of housing is positive. Studies around the world have shown that housing demand increases approximately proportionately with income. As living standards rise, therefore, everyone aspires to better accommodation.

The UK has a housing shortage consequently not simply because of demographic pressures. In fact, the impact of rising living standards on growth in housing demand is significantly greater than that from demographics alone, because living standards increase at a much faster rate than does the population. This will continue to be the case in the future (recessions apart).

This underlying demand dynamic contrasts with the situation in commercial property. Firms are always trying to limit their use of resources to produce any given amount of output and, with the help of technology and innovations, they manage to do so over time. By doing so, they increase general wealth and prosperity.

The spirit of economy in production generally includes minimising the use of buildings. The expanding and changing nature of national output has greatly increased the use of commercial buildings in recent history but there is no inevitable fixed association between them.

The key point here is that real estate is a cost to a producer – on which they wish to economise; whereas it is a benefit for housing consumers and they always want more, if they can afford it.

On the supply side, the negative impact of planning constraints on the provision of all types of real estate has been well-documented in the UK. This keeps prices high as supply cannot adequately expand to meet demand and there seems no prospect of a major policy shift. As a result, new property supply will continue to be restricted and more expensive than otherwise in the future.

Yet, the impact of planning constraints is probably significantly greater in residential. This is because of an issue of political economy: commercial buildings are seen as more politically acceptable.

The direct relationship between the supply of commercial buildings and economic and employment benefits is widely recognised by politicians and voters. Without places to work in, there can be no employment and economic activity. Therefore, the supply of new commercial buildings, though it faces constraints in the planning system, generally responds to market forces more readily than does that of residential.

Britain is exceptionally poor at providing new residential accommodation, so it is unsurprising that the long-run difference in the growth of capital values between commercial and housing is particularly high in this country. This imbalance between long-run capital growth of housing and commercial property is likely to stay and be greatest in the regions with the strongest growth, but most restrictive planning, especially London and the South East.
DEPRECIATION.

Investment decisions are influenced by depreciation concerns. Buildings and their contents wear out with use and age, so that part of the initial capital value of a property is being used up on a continuous basis. After a time, buildings may become worn out and dated internally and externally and may become less suited to contemporary requirements, even if adequately maintained. Substantial refurbishment or replacement eventually becomes necessary.

Recent research also highlights that depreciation not only affects costs and capital values but rental streams as well. It found that UK offices experience rental depreciation of 0.8% a year as they age.15

Depreciation is widely recognised as relevant in assessing returns with regard to commercial property; though precise measures remain problematic and the area is under-researched. The situation is less widely recognised in residential and there is little information and analysis with regard to housing investment.

Physical depreciation should not be confused with general capital value appreciation. Residential asset values will normally move in the direction of market trends but older, un-refurbished buildings will fail to command the prices of newer/refurbished ones.

There are grounds to think that depreciation is lower in residential than in commercial property. There are a variety of reasons for expecting this to be the case:

1. **Complexity.** Residential buildings are often simpler structures than commercial ones and, so, are less costly to refurbish.

2. **Technological intensity.** Residential buildings are less technically complicated than commercial ones. Commercial buildings often contain much complex plant, equipment, and assorted ‘plumbing’. All of it has a finite life and is costly and time-consuming to replace.

3. **Facilities matter but are flexible to upgrade.** One of the selling points of large-scale residential developments are the facilities that can be offered including gyms, public spaces, leading edge IT, and various public and social facilities. However, once again, these are invariably far easier and cheaper to maintain and upgrade than are commercial property equivalents.

4. **Adaptability.** A commercial structures’ usefulness is associated with how well it adapts to contemporary business technologies. Those technologies may change radically over time causing buildings to become obsolete long before they are physically worn out. The location of business activity may also change. The so-called ‘Crisis of the High Street’ illustrates both of these dynamics well.

By contrast, living space is fairly unchanging in content, so that housing can be relatively easily adapted to modern living requirements repeatedly over many years. The desirability of neighbourhoods also frequently persists over long-periods of time, especially in housing-supply-constrained Britain.

5. **Fashion/design.** Outside of a few iconic prestige buildings, commercial property has less resilience to changes in fashion and tastes than does most housing.

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15 N. Crosby and S. Dunaway, Depreciation of commercial investment property in the UK, IPPF 2011.
TAXATION.

TAXATION is clearly an important consideration when undertaking residential property investment as it influences net returns. As taxation varies across different types of investor, moreover, the incentives and mix of specific types of investor in residential is affected.

UK TAXATION BOOSTS OWNER OCCUPATION

In general, owner occupation receives favourable tax treatment over private renting. The two major advantages it has are an absence of tax on equity (i.e. net taxes on imputed rental income) and tax-free capital gains. However, there is a partial counter-balance because homeowners cannot deduct mortgage interest from their tax bills, though businesses and private investors can. However, this counter-effect is weak in an era of low interest rates.

There are important market impacts of taxation, via the consequences it has for property values and rent levels. Residential prices are increased by the tax breaks offered to owner occupiers, because such breaks become capitalised at least to a degree into house and land prices. The higher tax burdens on landlords conversely push up rents relative to house prices.

These tax advantages of owner occupation encourage more people to own than to rent where otherwise it would be the case. However, these tax effects operate differentially on pricing across market segments, which raise important issues for investors.

THE TAX BENEFITS OF OWNER OCCUPATION ARE LOWEST IN STARTER/RENTER NEW BUILD MARKETS.

The UK tax advantages of owner occupation mainly accrue to those who have been home owners for a long time. Consequently, tax-distorting effects on residential prices are going to be greatest in locations and market segments where previous homeowners are the most active and least where they are the most absent. When looked at from an investment point of view, this conclusion provides insights into where the housing market is likely most favourable for them in terms of the differences between the rents they need to charge to obtain a good return and the out-goings and returns an owner occupier would have in a similar property. In other words, for some types of housing and locations, owner occupation offers tougher tax-induced competition for investors than in other segments.

First-time buyers have little equity and obviously no capital gains from house prices rises and, hence, hardly benefit from the tax largesse aimed at more established homeowners. They are likely to be looking for homes in similar locations to investors aiming to house comparable types of people as their tenants. Urban, new build, apartment developments, outside of the more prestigious locations, clearly fall within that category. Focusing on apartment markets limits the underlying tax advantage accruing to homeowners.

TAXATION BIASES INFLUENCE INVESTOR MODELS.

Privately rented housing is taxed less generously in the UK than in many other countries. In particular, there is an absence of a depreciation allowance; tight rules on capital gains; and significant inheritance taxes that affect quite a number of private investors and their families. This affects the choices people make about whether to be a homeowner or a renter but, in addition, impacts on investors. Quite how depends on the location, scale, and type of entity. Each may be affected by taxation rules differentially with regard to their decisions regarding investment in residential property. Tax rules, therefore, create biases and distortions the outcomes of which deter some potential investors and distort pricing.

For example, UK entities, such as Pension Funds that are not subject to tax, have different requirements from those that are. Similarly, UK domiciled investors face distinct tax horizons to those that are non-domiciled. To date, residential REIT vehicles that would overcome some of these tax-distorting effects have not successfully emerged.

Recent legislation has improved the potential for residential REITs. Set up costs have been lowered by reducing government changes (though overall set costs remain a significant barrier, especially at smaller scales). AIM listing is feasible, and multi-ownership rules have been relaxed. The previous stamp duty (SDLT) bias on bulk purchases of residential property has also been removed. The government has also raised the value it is prepared to commit to its bulk-to-rent scheme to £1bn, with the hope that state equity injections will help to kick-start development.

It remains to be seen whether these actions will ignite activity in UK residential REITs. Set up costs and performance uncertainties in an untired market remain, amongst other matters. A key problem is product availability; given the limited amount of large-scale residential stock in the UK and the few new large scale schemes coming on stream.

The taxation framework facing investors in UK residential property remains complex, although that should not act as a deterrent to large-scale investors. Nonetheless, unforeseen consequences of taxation policy exist and the ramifications have not been fully explored.

An example is the incidence of (20%) VAT on housing related services. In-house teams – and the own labour of small-scale landlords – incur no liability but when such services are purchased they do. Those tax costs cannot then be offset against rent revenues, as house rent is non-VAT-able. This differs from commercial property where such VAT can be offset.

As a result, this limits the ability of third party service providers to specialise, innovate, and gain scale economies: either as standalone service providers, or through extending the scope of in-house service teams’ capabilities by offering them to other housing investors. Key areas of specialisation, as seen in the USA and elsewhere, are hold back in the UK by this substantial tax bias. Furthermore, this VAT issue biases costs...

structures against schemes that are too small to keep in-house service teams fully employed, although that are still large in typical housing market terms.

**POLICY BARRIERS REMAIN**

Government has shown enthusiasm for large-scale investor interest in private renting and the policy agenda is moving in the direction of encouraging more. An important and vital area, if the sector is to grow, is obviously the creation of many new developments: the building up a stock of property for the benefit of consumers and investors alike. But commentators have noted the only limited impact of such initiatives on the ground to date, despite a congruence of key elements necessary to trigger such activity. "Multi-family [housebuilding] is leading the recovery in the USA but it is practically non-existent here."

In general, there have been far more words than actions: with the number of schemes built or in the pipeline few in number. This points to remaining policy barriers to new building rather than investor inertia. Central and local government attitudes and policies towards development remain housing supply constraints.

**ASSURED SHORTHOLD TENANCIES ARE FUNDAMENTAL TO THE SUCCESS OF THE UK PRIVATE RENTED SECTOR**

A successful private rented sector of substantial size has grown up on the basis of assured shorthold tenancies (AST). They give investors confidence in their ability to set rents in relation to market forces and to gain vacant possession, if necessary. In turn, those factors give mortgage institutions and other lenders the confidence to lend at competitive rates to investors. Tenants have gained immeasurably from this flood of investment. Supply has greatly expanded and with it choice. The resultant competition has improved quality and improved the keenness of rent setting.

Even in situations where large-scale investors are contemplating offering alternative tenancy contracts to standard ASTs, this is planned to be done on the presumption that ASTs will remain predominant. This gives them and their backers the confidence that there is a Plan B (revert to ASTs) and, so, enables them to experiment. It also acts as a benchmark for comparison and for measurement of the level of market rents.

All political parties recognise the success of a free market in private renting in the UK and are committed to maintaining it. A fundamental part of the private rented sector’s institutional framework is the AST. Any reform to tenancy contracts would cause irreparable damage if its principles were not accepted and sustained.

**“THE UK TAX ADVANTAGES OF OWNER OCCUPATION MAINLY ACCRUE TO THOSE WHO HAVE BEEN HOME OWNERS FOR A LONG-TIME.”**

THE IMPLICATIONS OF VARIOUS RESIDENTIAL INVESTMENT OPTIONS.

A larger-scale investor can consider a number of ways of investing in residential property. The different vehicles offer distinct opportunities and risks, which will be discussed both in this section, which looks at three potential investment options (direct, indirect, build and hold), and the following one, which looks at asset management and revenue optimisation.

Various sub-sectors and options are available but only three important distinctions will be examined here as they highlight key features of potential investment strategies.

1. DIRECT INVESTMENT.

The advantages of residential direct investment parallel those in commercial property:
- Control of the core asset base
- Full information about asset performance
- An ability to gain the full benefits of the asset’s investment characteristics without the intermediation of other investment forms – such as occurs when purchasing shares of a property company, whose performance if listed then partly reflects that of equities as a whole
- The possibility to benchmark investment performance in an unequivocal manner against some external indicator

Against these advantages, there are several issues that may arise. For example, a diverse portfolio of individually owned properties would incur high transaction, management and maintenance costs. However, the situation is potentially different with larger schemes and the issues will be considered further below.

2. INDIRECT INVESTMENT.

Indirect involvement in residential properties can be achieved by purchasing stakes in specialist residential property companies, including REITs.

Liquidity is likely to be good through indirect investment, because it should be relatively easy and cheap to trade such equity. In addition, the asset specific costs and risks associated with residential investment are going to be priced into the value of the entity’s stock and reflected in returns and their volatility. A potential wider range of asset and spatial locations may also be invested in for any given investment compared to the direct route by taking a partial interest in entities with diverse portfolios.

However, along with such benefits come the downsides of loss of control, imperfect information, and a blurring of the sources of return compared to the direct investment route, described above. Specialist firms may also take on trading and development roles as well as holding portfolios of residential assets and those activities tend to be more risky ones.

At present, there are only a limited number of opportunities to invest indirectly in UK residential. Moreover, some players are active only in specialist areas that have their own ‘sub-market’ characteristics and performance, such as student housing or retirement homes. The options to invest indirectly in mainstream residential remain limited.

There is, of course, a ‘chicken-and-egg’ type of dilemma here. The greater the interest of investors in the indirect option, the larger the number of firms trading as specialist residential investors is likely to be, and vice versa. However, this sector may well expand in the future, especially as the conditions for establishing residential REITs improve. Yet, the opportunities to invest in UK residential on a scale relative to that in the USA via this route do not currently exist. Even if expansion occurs, that growth will take some time to evolve.

3. BUILD-AND-HOLD.

Another direct option for a residential investment strategy is to be pro-active and develop bespoke schemes for subsequent holding and, possibly, trading.

Housing associations are utilising this approach as they diversify out of social into market renting. So do most market specialists in fields such as student housing, sub-contracting the design and building work out to contractors.

This approach does have the advantage for investors of being able to engage in the conception of the sorts of development they would like to own. But, in the absence of a specific ‘edge’, such as a prized-but-cheap site or a profitable innovative project, the risk-adjusted total return is unlikely to be enhanced above that achieved through investing in completed schemes.

In addition, residential development is a significantly more risky activity than owning buildings alone: both in terms of the extra project specific risks (associated with build costs/time lines and the market success of completed schemes) and the state of the market when projects come on stream. Finally, specialist developers may often be more skilled at site assembly, managing risks, and spotting consumer and market trends than institutions with limited experience in that marketplace. Joint vehicles can limit some of those issues but they would also come at a price.

These considerations should not necessarily deter investors from embarking on build-and-hold strategies when such seemingly abundant opportunities exist in UK residential. Instead, they point to a need to weigh up returns appropriately when devising strategies.
INVESTMENT AND PROPERTY MANAGEMENT.

Property management highlights the distinctiveness of residential real estate from that in commercial sectors. Many aspects of day-to-day property management are typically borne by tenants under the terms of commercial leases, often including incidental repairs and regular maintenance. But this is not the case in residential.

In a similar vein, in many types of commercial property, tenant turnover is often limited. Many commercial tenants will be well-known, solid enterprises; with infinitesimally small default risk or prospects of rent arrears. Again, residential is typically different from that with short leases and anonymous tenant profiles. However, this characteristic offers more of an opportunity than a threat.

The importance of a handful of tenants in much commercial property brings with it specific risks and strong dependencies on a handful of relationships that do not exist in residential. Residential is a large numbers activity that, as already mentioned, makes key performance characteristics more predictable. Success depends on the appropriate marketing strategies and products in the context of a mass market for quality homes.

Making sense of large-scale residential investment.

Property management and maintenance in residential is more intensive, hands-on in nature and costly. Investors highlight this as an issue when commenting on residential investment. However, such features of residential again focus attention on the fact that it is a different product than commercial property, one that generally has a higher customer service element within it characteristics, moreover, that are priced into the product.

An analogy can illustrate the point. Some large-scale commercial property investors are active in hotels. Yet, it could be argued that the hotel industry has many of the so-called problems of residential: the large - high turnover, vacancy, etc. – and it is a far more volatile asset than residential. However, it is recognised that in the hotel trade these characteristics are priced into the product offer, but the same is true in residential.

Furthermore, specialist, skilled management is utilised in the hotel industry. Distinct marketing strategies are developed in order to product differentiate by market segment, with targeted price and service offers. Net revenues can be maximised by branding, market focus (mass, boutique, prestige, etc.), location (city centre, leisure vs business, etc.), scale, and diversification.

Similar features exist and comparable strategies can be adopted in the housing industry. In other words, the additional service offer in residential when compared to much commercial – if appropriately treated – brings in additional revenue. Pricing in residential encompasses its characteristics. Product differentiation and related strategies are important in order to achieve effective pricing and successful direct investment.

A feature of the residential market is that small-scale landlords are formidable competitors in the scattered rental properties within the existing stock that characterise most of the UK’s private rented housing, as in other countries. The cost base of a small landlord is typically lower than it would be for a large-enterprise which attempted a strategy of investing in extensive holdings of that type. The cost difference is heightened by many small investors under-pricing their labour services.

Large-scale investors, therefore, operate most effectively where size matters. Scale-economies and product differentiation enable large-scale investors to avoid competing hands-on. They enable the creation of living environments desired by particular types of tenants, who are willing-to-pay for the housing service bundle on offer. Yet, outside of specialist rental markets, few existing developments command the scale where such benefits are maximised.

Though currently limited in the mainstream UK residential market, such types of project where large-scale investors can thrive are readily apparent in most US cities. The options range from wholly-owned apartment blocks through to village-style communities.

The future of successful large-scale investment in the mainstream UK private rented sector can be found by looking across the North Atlantic, in taxation and regulatory constraints can be made to accommodate it.

CONTAINING OPERATING COSTS.

A key distinction between residential and commercial investments is that the former’s rents are paid gross of operating costs; the latter’s are generally not. In residential investments, the income received by an investor is net of these costs.

A key area where large-scale professional property management can play an important role is with regards to managing these operating costs. At present, there is little evidence on their real incidence.

Figures, such as 30% of gross revenues, are often quoted and have reached a quasi-mystical status but provide no in-depth understanding.

Costs break down into a number of distinctive categories: service charges, operating costs (lettings, legal, administrative, etc.), vacancies, plus maintenance and repairs are the principal items, prior to depreciation. Generalisations are problematic, given such range and variety, and clearly differ substantially between newly built and older property. The latter is an important consideration in the UK where large parts of the urban rental stock are more than 100 years old.

It has been demonstrated in other countries that large-scale professional property management can play an important part in stabilising and reducing those costs, while facilitating a quality service offer.

Furthermore, some cost items are central to the tenant packages on offer. So, if they are appropriately managed, they can be revenue enhancing in themselves: by reducing vacancy rates below the norm; through enhancing rental income directly; or by gathering further returns through premium service and other package charges and revenues. Scale economies and professionalism obviously count for much in these areas.

The UK has yet to experience the opportunities that clearly exist in these areas. In this context, the launch of East Village at the Queen Elizabeth Olympic Park offers a unique insight in the future.
CONCLUSIONS.

The investment case for further large-scale investment in UK residential rests on a number of firm pillars:

- A strong market, driven by current and forecast demand.
- The assets’ characteristics relative to other types of real estate.
- Favourable income-matching and inflation hedging properties.
- Severe constraints on housing supply, particularly in areas of greatest demand.
- The current state of the housing market cycle.
- The capability of large-scale developments to stand out in the market place, if appropriately conceived and managed.
- The enduring value of the residential product and its depreciation characteristics.

Undoubtedly, there are concerns about the investment characteristics of residential property but, as has been argued here, many of them are not as great as is often thought. For example, the adjustment of rents means that income streams over time reflect capital values. Similarly, the distinctive features of residential should not be seen as solely raising costs but are part of the nature of the product and are reflected in pricing and revenue streams as well.

The UK has a clear gap in its lack of large-scale investor residential asset holdings relative to those existing elsewhere. In a competitive economy, it is hard to blame investor inertia for this long-lasting state of affairs. Public policy, regulation and a lack of national and local understanding of the conditions necessary for large-scale development have in combination acted as major barriers. Government is now shifting its stance but there is some way to go to facilitate the expansion of this type of accommodation through major building programmes, though they are desperately needed in housing starved Britain.

ABOUT GET LIVING LONDON.

Get Living London is a new residential owner and rental management company that is creating London’s newest neighbourhood at East Village, the first legacy neighbourhood from the 2012 London Olympic and Paralympic Games.

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