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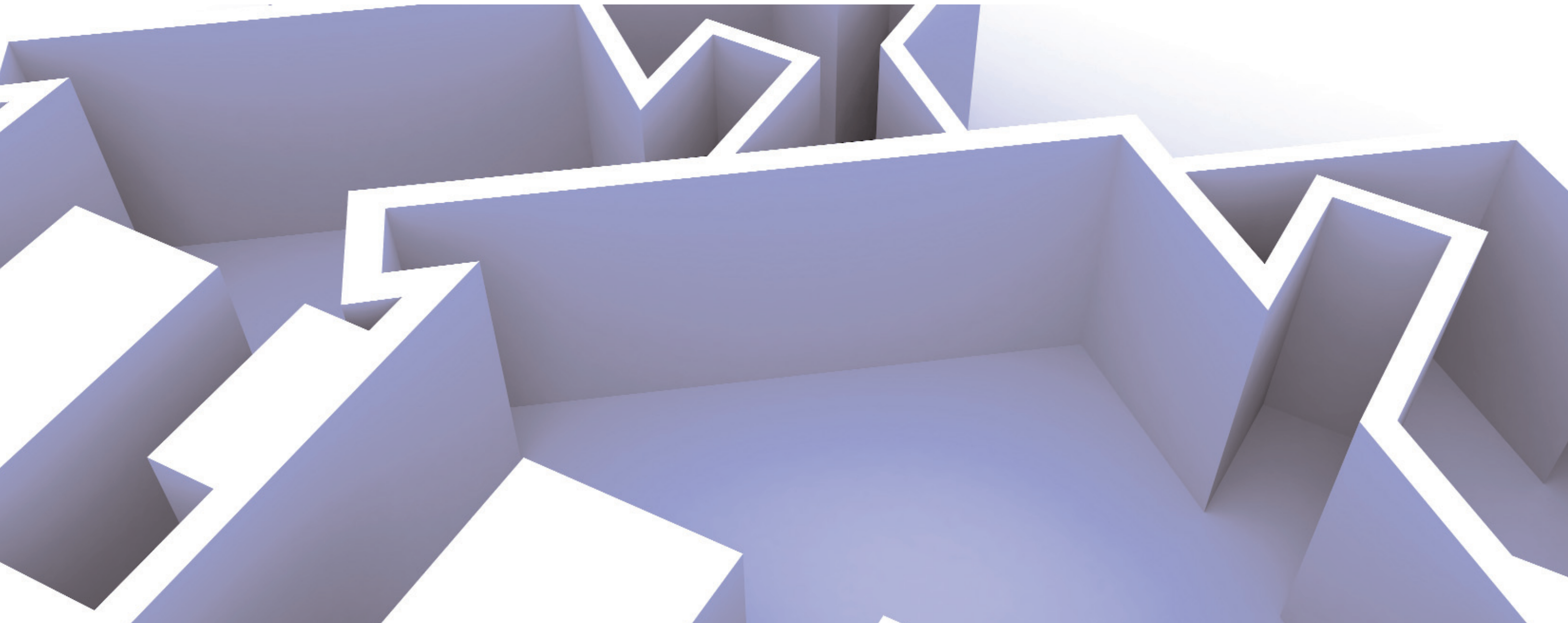
Overcoming barriers to institutional investment in residential property

By **Jacqui Daly** (Savills)



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Executive summary

Investment from large institutions (such as large pension funds or insurance companies) is appealing to policy makers because:

- it can help support large new developments that are crucial to meeting national and regional housebuilding targets

- institutions could deliver higher quality, more professionally managed rented property than smaller 'buy-to-let' investors due to their economies of scale and professional experience

- the stable income returns (rent) and high total returns (rent plus capital growth), and prospects for portfolio diversification should make residential attractive to investors. However, institutional interest has been very limited so far, both in absolute terms and in comparison with other developed economies such as the Netherlands or the US.

Barriers

- There are a number of factors cited by institutional investors as to why residential is unattractive, many of which relate to the differences between residential property and commercial property investments. Central to this is the relatively low level of income return generated by residential investments.

- A key drawback is also the relative uncertainty of the income stream given its shorter leases, financially weaker tenants and the fact that unlike commercial property, residential is not let on Full Repairing and Insuring (FRI) terms.

- These factors, together with the relatively small lot size and fragmentation of the market, result in much higher management costs that absorb a disproportionately large share of the already low income return as compared to commercial property investments. But the development of larger purpose built properties for let could enable investors to reduce management costs through economies of scale and design out issues that increase running costs.

- Compared to smaller 'buy-to-let' investors, some of whom will be driven by capital growth, institutional investors place greater weight on the income component of total returns. This may reflect their experience of the commercial property market where values tend to be determined by the current and expected future income produced by a property.

- With around 70 per cent of the residential market in the hands of owner-occupiers, capital values are determined virtually independently of the income stream. This may also be perceived to be a risk.

- In the commercial property market a riskier income stream would result in a higher yield requirement on the capital invested, but residential yields are well below those of the commercial market.

- It is likely that only the larger institutional investors would look to invest a proportion of their portfolios in residential. However, there is little existing stock which would meet their target lot size criteria (>£100m). Large regeneration schemes could offer the potential investment scale in the future.

Potential solutions

- One solution is to structure the income stream of residential property like a commercial investment. The student accommodation market is a very successful example of this. Its investment performance is based on the size and potential of the income stream generated by the asset and the strength of the covenant, rather like commercial property. Because it is purpose built for the student market it also does not attract the same level of affordable housing requirements as general market housing, which improves its financial viability.

- To help increase the overall supply of housing a 'build to let' sector should be encouraged. This would require greater flexibility over what determines affordable housing. Bespoke rented housing should not need the same level of section 106 requirements. This is because investors in new rental accommodation will be required to invest far higher sums of capital than under traditional development models, since their money will be tied up in the long term, whereas traditional house builders sell on immediately upon completion.

- Such a model could prove particularly helpful on large-scale urban sites, where the pre-sale of units will help developers raise the capital they need for development. The pace of development would also improve because it would not be hampered by the speed at which owner-occupied units can be absorbed into the market place.

- Alternatively, rented housing that is designed and built for the rental market under a 'build to let' model could be delivered through a designated planning use class. This would lower the land value. At present, residential housing is developed solely for owner-occupiers, with its value determined solely by this market. If housing was developed that could only be rented and not sold to the owner-occupied market, this would have an impact on the land values by making the product an income-driven asset.

- Central government should consider fiscal measures to further support 'build to let'. These might include a tax allowance against rental costs for landlords that rent out property to remove the double taxation that they incur on management. There could be a stamp duty concession for properties purchased for rent, as long as they were held for rent for a set period. If they were sold within that period, full stamp duty would apply. This would act as an incentive to provide long-term rental property.

- Professional managers of rented stock should become accredited landlords adhering to a set of standards covering both private sector organisations and registered social landlords. A mutually agreed set of standards for management of rented housing would have to be developed.

Investor types - motivations, barriers and investment vehicles used by the different investor groups

	Motivations	Barriers	Investment vehicles
Institutional investors	Diversification Potential investment scale Potential for strong covenants Lack of investment grade stock in other sectors Outlook for residential compared to commercial Matching liabilities	Disconnect between price and value Low income return Relatively high management costs Small lot sizes and lack of investment scale Pricing mechanisms and discount to vacant possession value (VPV) Sentiment Lack of skills and expertise	Off-shore vehicles (tax efficient especially for tax exempt investors) On-shore investment vehicles Indirect funds (specialist skills and expertise) Collective investment vehicles (investment scale)
Traditional property companies	Enhance value on strategic sites Capture regeneration premium Retain management control Generate returns through development	Capital intensive to retain ownership Exit routes uncertain Limited gearing potential Lack of understanding of sector	Traditional property company structure (private limited company) Public limited company listed on the stock exchange
Traditional large-scale residential investors	Investment returns linked to earnings Stable returns Ability to implement regular rent reviews Attracts high levels of capital growth High demand for rented housing	Owner-occupiers determine price Affordable housing requirement Transaction and trading costs	UK private property company structures for direct investors Indirect investment structures used to raise money from institutions Public companies - listed on UK stock exchange
Fund managers	Diversification Lack of investment-grade stock in other sectors Shared ownership/equity is effectively an FRI lease Matching liabilities to investor returns	Low yield restricts leveraging Fragmentation of shared ownership stock Restrictions in shared ownership market Lack of control as absent landlord in shared ownership market	Off-shore vehicles (tax efficient especially for tax exempt investors) On-shore investment vehicles Indirect funds (specialist skills and expertise) Collective investment vehicles (investment scale)

1 Introduction

The purpose of this research is to investigate a framework for increasing private institutional investment in residential property in order to increase the supply of new housing in London. There is a need for an increase in investment in residential property to help alleviate London's housing shortage. As a result, an understanding of the steps required to encourage more institutional investment in the residential sector is vital.

The focus of this study is on the private rented sector and the intermediate rented market, both of which have the potential to generate investment returns. The research explores and identifies reasons why investors invest in residential property, what motivates them and what are perceived to be the main barriers to investment in the sector. It also attempts to offer potential routes forward to encourage investment, improve management and increase supply.

The Calcutt Review of house building recognises the importance of private finance in the residential market, citing the objective for the government to create a framework in which the house-building industry freely takes investment decisions to deliver the target for new homes.

This research has been undertaken by Savills on behalf of the Greater London Authority (GLA) and the British Property Federation (BPF) and is based principally on the interview responses given by senior executives active in the residential and commercial property sectors. We are grateful to all those who gave their time to participate in the project as interviewees or members of our steering group.

2 Investors in residential property

This section of the report presents the findings of the interviews conducted with a range of investor groups. It identifies the reasons why investors invest in the residential sector and the factors preventing wider investment. It draws out the key principles that should frame an investment vehicle.

There were four investor groups included in the first stage of the research. In total 20 individuals from 15 organisations were interviewed. Investors fell into the following categories:

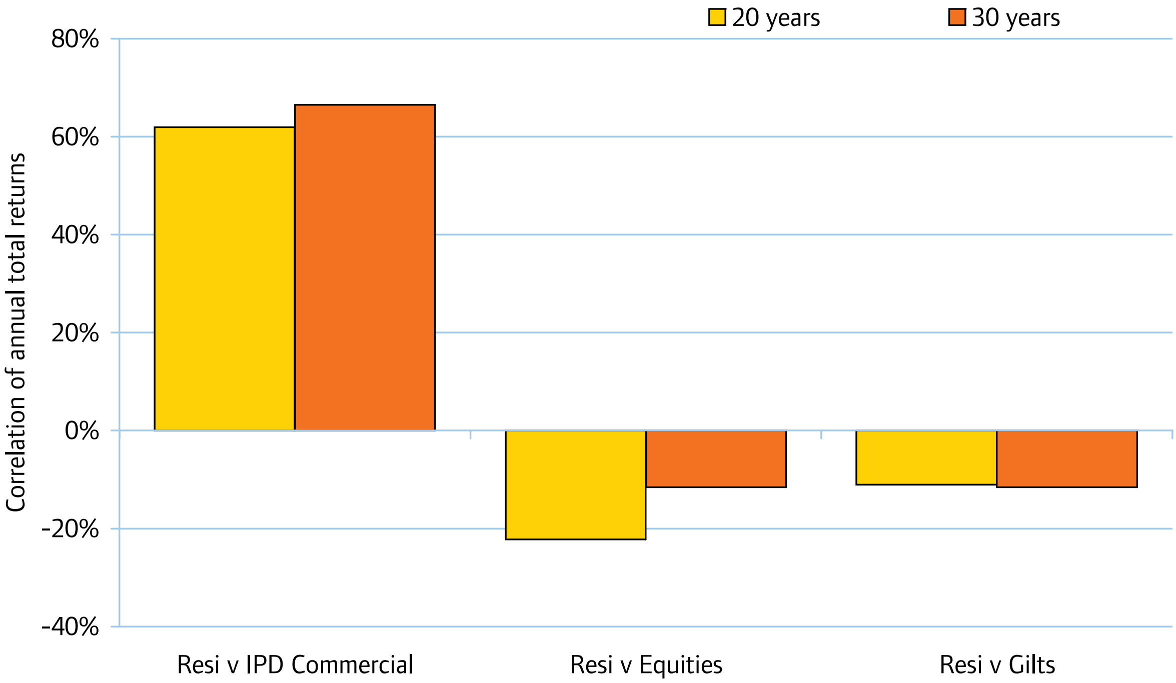
- institutional investors
- traditional property companies
- traditional residential investors
- fund managers.

2.1 Institutional investment objectives

Institutional investors (pension funds and insurance companies) are the largest private sector investors in the UK, managing a huge pool of investment capital spread across a number of different asset classes. A key reason for spreading their investment across a number of different assets is to improve performance and reduce the volatility of portfolio performance.

Institutional investors, most especially life funds, have a preference for higher yielding assets. Property is regarded favourably by insurance companies because it generally produces a higher yield, and rental income is delivered gross of tax. As shown in Figure 1, residential property investments have exhibited a low correlation with equities and gilts over an extended period and therefore can add valuable diversification benefits within a multi-asset portfolio. Yet it remains a neglected asset class for the vast majority of institutional investors in the UK.

Figure 1: Strong diversification benefits of investing in residential



Source: Savills Research

There is strong demand for fixed interest securities from the annuity funds but institutional liabilities tend to be real in nature – ie they increase over time as prices/wages increase. As a result, institutional investors need to include real assets within their portfolios such as index-linked securities, equities and property.

Commercial property is regarded as a hybrid having both fixed interest investment characteristics, by virtue of its long leases and upward only rent reviews, and equity characteristics as rental growth can increase capital values. These characteristics, together with the low correlation with other assets, make commercial property attractive to institutional investors.

However, only a small proportion of residential investments offer these characteristics, with the majority of tenants being individuals not companies and leases generally being of short duration. The strength of the covenant (ie the tenant) is the important factor for institutional investors.

In the commercial world a government tenant in an office building will be seen as an attractive covenant. Some income streams from housing may therefore be attractive investments because of the quality of the entity paying the rent. For example, a long lease to a registered social landlord (RSL) or where rents are in effect 'government backed' and linked to inflation, might be seen as an attractive proposition in these terms. The 'covenant' in this instance is the RSL and the attractiveness of the RSL will be based on their ability to meet the terms of the lease and pay rent as well as the security of their business model.

Therefore, one potential route forward is for institutions to sit behind RSLs and provide financial backing for an agreed target rate of return. This was described by one fund manger who stated that 'if you had an RSL and the RSL would give you an overriding lease with some sort of indexing, you're buying a bond'. There is strong demand from institutional investors for a 30-year inflation linked cash flow. In that respect, social housing could be an ideal asset because it is linked to retail price index (RPI) and underwritten (ie housing benefit reduces the risk of non-payment of rents) by the government.

In addition, the under-supply of social units means little or no risk of voids. If it is underwritten in this way the risk premium attached to the investment will be lower thereby producing higher net returns for the investor. In reality, the low return from social housing in absolute terms means that an RSL is more likely to derive acceptable levels of returns from a spread of different types of residential assets.

RSLs have the potential to offer investors good covenants and annuity style investments to underpin the performance of a residential fund.

De-risking the income stream can be attractive to investors as evidenced by the success of the student accommodation market where educational institutions have the letting risk in exchange for better quality accommodation and signing long leases often with fixed uplifts. These have proved very attractive to institutional investors with fund managers such as Morley, Cordea Savills and Quintain having acquired these investments and this form of investment being the traditional business model of the property company Unite as shown in Table 1. In addition, these models have proved to be successful with an RSL managing the stock, as is the case with the Morley student investment fund.

It has been proved that de-risking residential property investment cash flows and changing them to be more like commercial investments makes residential attractive to investors.

Table 1: Traditional student business model of Unite

Sale and leaseback with nomination agreements or Fully Repairing and Insuring (FRI) leases with nomination agreements An outright purchase from the university with provision to nomination agreement occurs where the investor purchases accommodation directly from the university and the university agrees to nominate a certain proportion of students for a number of years. During this period, the university has control over the student nominations to the halls of residence and often has an influence on the terms of letting and service level. After the nomination agreement has expired, the university no longer has direct control over the flow of students to, and occupation of, those halls of residence. For the investor, planning constraints rule out the possibility of alternative uses for on-campus accommodation. Therefore, when the nomination agreement comes to an end, the owner will need to maintain the standards of accommodation in order to retain adequate occupancy by students, and, therefore, income. FRI leases tend to be for longer duration than nomination agreements (say 20 to 30 years), and generally offer a low-risk investment opportunity. During this period the university has responsibility for the property as if it owned it, paying the investor a net income after costs, operations and profit margin as with any other commercial investment. As the market has evolved we have seen agreements include internal repairing and insuring lease terms. Under these terms the investor has external maintenance responsibility, leaving the university responsible for letting and soft management risk which is increasingly popular. Therefore, the income stream is ultimately secure for the term of the lease. Asset management should be less intensive, which should also lead to lower management fees. Overall there is less risk involved in this type of investment, and this should be reflected in the cost of debt and ultimately the investment yield.

2.2 Investment characteristics of private rented housing

A key attraction of residential property to long-term investors is that the income stream from housing is linked to wage growth and can offer investors an even better hedge to their liabilities than commercial property which is more closely linked to the slower growing retail price growth series and other property market indicators.

Residential investments are priced at a discount to vacant possession value. This represents the amount that would be achieved if the property were sold vacant on the open market, to an owner-occupier. Therefore, residential prices are dictated by the owner-occupied market and do not relate to demand from residential property investors. If the residential asset is let on an assured shorthold tenancy, the value of the asset will be discounted.

Institutional investors find it difficult to understand the pricing mechanisms for residential property. Normally, assets that are income-producing sell at a premium rather than a discount. The discount applied to residential property investments can actually drive value for a large investor because the assumption is that they can break up the portfolio and sell to the owner-occupied market at a later date. However, in reality this goes against the objectives of long-term residential investment management.

Pricing of residential property investments would be more attractive if they reflected the cash flow and worth to investors, not owner-occupier values.

Some traditional property companies and fund managers have been involved in large-scale urban regeneration but very few hold on to the residential elements of their developments, preferring to realise short-term profits (and repay debt) by selling into the owner-occupier market. This short-term model is also evident in the behaviour of large house builders for whom the lower returns of owning and/or operating rented investment portfolios would dilute the performance of their highly geared development activities.

A handful of property companies are now recognising the benefits of holding on to a proportion of larger developments. For example, developments such as Brindley Place in Birmingham have shown that the prices achieved toward the end of the regeneration project are significantly higher than those at the start.

There is in effect a premium derived from the regeneration process and the premium kicks in towards the end rather than at the start. This is especially true in city centre areas that have not previously been for residential use. As the area regenerates and people are attracted to it, the increase in demand leads to an increase in house prices. Developers are beginning to recognise the effect of regeneration and that pioneers in new residential areas benefit from the premium derived from the regeneration process.

Nevertheless, the exit route remains a sale into the owner-occupier market rather than to an investor, as the expectation is to obtain a better price in the owner-occupier market where prices fully reflect VPV. This discount is evident in the new build market where potential rental schemes (student or mainstream) are compared to the price that would be achieved on a £ per sq ft basis, if the scheme is developed for the owner-occupied market. Higher levels of capital investment are required if the aim is to retain ownership of the units for rental purposes, because developers do not have the capital receipts from outright sale.

There is an opportunity for developers to link up with fund mangers (who are investing on behalf of institutions) to fund units that are destined for the rental market but priced at a discount.

Property companies involved in creating new towns and places are seeking ways to maximise value by holding on to the residential element until later in the regeneration process. One respondent identified that the objectives for pursuing this strategy are for strategic reasons, described as:

- de-risking the scheme by pre-selling to an investment fund and therefore not being wholly reliant on sales at completion
- managing the new environment as a 'place' to enhance future commercial and residential values
- retaining control of the environment and managing the rental properties in a cohesive and cost-effective way
- capturing regeneration 'premium' uplift towards the final stages of the regeneration process
- securing fund management fees for the investment fund investing on behalf of a range of clients.

An investment model that encourages investors to retain ownership of residential units within large-scale urban regeneration should be developed.

To create an investment model that would encourage investors to retain ownership within large-scale urban regeneration might require fiscal or planning measures. At present, residential is developed for the owner-occupied market with values determined by the owner-occupied market. Essentially, housing that is developed and sold in the owner-occupied market always generates higher development values than housing that is developed for rent. Therefore, housing developed for the rental market that could not be sold to the owner-occupied market for a certain period would impact on land and development values. This is the rationale for a distinct planning use class.

A distinct planning class for rented property would effectively create a separate market within the residential sector. In economic terms the value of properties in that sector would be expected to relate to rental returns, as in the commercial property sector, and so would be expected to remove the 'owner-occupier premium' on residential. This would reduce the initial cost of investing in rental property, and so improve the percentage return on investments through the rental income stream.

However, it would also have the effect of shutting investors out of capital value growth driven by owner-occupier demand, leading to lower total returns on their investment in residential. However, as long as the asset does not remain rented in perpetuity, there would be redevelopment potential that would be built into the value of the asset. Therefore, at some point in the future (such as 10 or 20 years), the rented housing could be redeveloped for either the owner-occupied market or the rented sector depending on housing demand. This would provide long-term rented housing as well as an investment asset class.

A residential market which is not for owner-occupiers and can only be for rental purposes will be priced on investment values, rather than owner-occupier values, though this could have the effect of reducing short-term total returns.

Institutional investors also identified that there could be a role for institutions in supporting city centre regeneration funds, described as 'marrying together the financial muscle of the institutions, with the local knowledge and expertise of regeneration specialists'. Morley's Igloo Fund is an example of a fund manager investing institutional capital in regeneration activities in the UK. However, this model tends to be a development gain rather than a long-term residential investment strategy because units are sold on completion rather than being retained for the rental market.

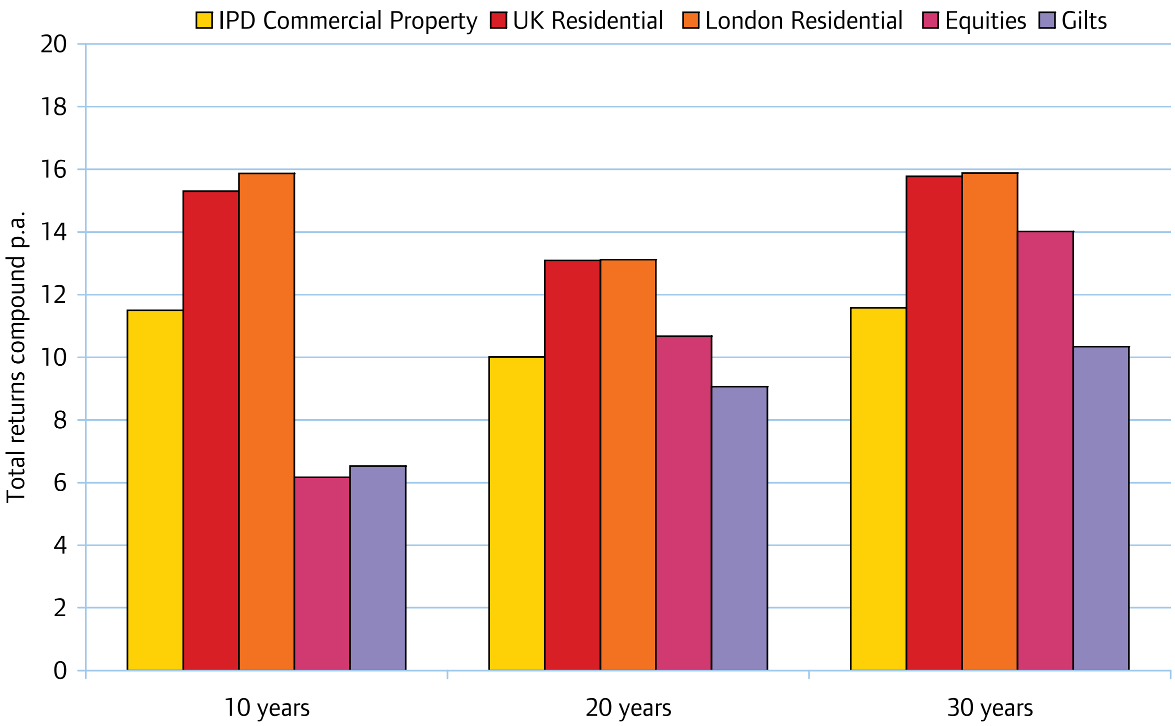
According to fund managers included in the research, investors are less concerned with the type of investment vehicle because there are many well-established vehicle structures in the market that will suit different types of investors. One respondent identified that the residential assets 'sit behind the vehicle that will meet the investor demand, and the type of investor dictates the type of investment vehicle'. Investors (institutional, private client or international) are generally more concerned with the investment fund meeting their objectives and requirements, in terms of:

- the investment period
- the structure of the return
- access to the return
- performance of the underlying assets
- performance and skill of the fund operator.

Fund managers use a variety of investment structures and try to match the investment returns to the profile of investors.

Fund managers reported that investors are increasingly interested in total returns, which is a reflection of the low-yield environment. This improves the potential attractiveness of the residential sector because it is a total return play with the returns driven by capital growth rather than income growth. As shown in Figure 2, residential property has a history of relatively high and stable total returns, outperforming the other mainstream asset classes over the last 10, 20 and 30-year time periods.

Figure 2: Annualised total returns



Source: Savills Research, IPD

However, even though total returns for residential have historically performed well, investors still place more importance on the income side of the return because it is predictable and certain, which allows them to match their liabilities with more certainty. Even when commercial property returns are low or negative, as was the case year in 2007, the income return is still higher than residential.

Table 2: Commercial and residential average total returns, split by income and capital growth

	Commercial real estate (IPD)			UK residential real estate (Savills)			London residential real estate (Savills)		
	Total returns	**Income return**	**Capital return**	**Total returns**	**Income return**	**Capital return**	**Total returns**	**Income return**	**Capital return**
1 year	-4.4	4.6	-8.6	10.2	3.2	7.0	10.0	3.0	7.0
3 year	10.9	5.1	5.6	9.4	3.3	6.1	8.0	3.1	4.9
5 year	12.4	5.7	6.4	11.6	3.5	8.1	10.5	3.2	7.3
10 year	11.7	6.3	5.0	15.5	4.5	11.0	16.1	4.5	11.6
20 year	10.4	6.9	3.5	13.4	5.5	8.0	13.8	5.6	8.2
30 year	11.9	6.7	5.2	16.2	6.2	10.0	16.5	6.3	10.2

Source: Savills, IPD

2.3 Barriers to investing in private rented housing

Residential investors face a number of barriers in the current market. To achieve acceptable levels of return, a large landlord must achieve critical mass. Residential landlords need to be big enough or have achieved sufficient economies of scale to absorb the costs of management through efficiency gains. The residential investment market environment in the UK prevents landlords from growing at an acceptable rate to achieve the scale required to attract external investors (ie meet target rates of return and investment lots sizes).

A market environment that favours large-scale investors will create the necessary economies of scale.

Key barriers in the residential investment market are the transaction and trading costs for large landlords because they are higher than for small landlords. This means that they find it difficult to compete with small landlords. Small landlords generally do not factor in the true cost of acquiring and running a residential investment. This is because they see it as a bricks and mortar investment which they themselves can manage, and any capital gains tax liability is likely to be offset by the increase in house prices during the investment period. In reality, this means that a small landlord will be willing to pay a higher price for an asset than a large landlord who is basing the acquisition price on the income and growth potential of the asset.

Small investors that purchase single assets also tend to pay lower transaction costs. A large investor will pay 4 per cent stamp duty for a pool of residential assets compared to 1 per cent for single assets under £250,000. This has an impact on the ability of investors to secure stock and on the performance of the money invested. Adding 4 per cent to the purchase price has a big impact on the performance of the investment and is largely the rationale behind the discount that is applied to VPV.

The current investment environment favours small-scale 'buy-to-let' investors who pay lower stamp duty and incur lower running costs.

For a large residential investor based in the UK, competing with consortium buyers or off-shore funds that do not pay tax is an obstacle. All three have different return requirements, use different levels of gearing and have different perceptions of risk. A consortium, which in recent years has been the model for a large number of overseas buyers, uses higher levels of debt and is mainly targeting capital growth. Because these buyers are using higher levels of debt, they can afford to pay a higher price for residential assets.

Similarly, an offshore fund that is investing on behalf of pension funds can also pay higher prices because these investors are tax exempt. This puts UK large-scale landlords at a disadvantage to other investor groups and explains why many UK landlords have been unable to grow their portfolios to the desired scale.

Institutional investors use off-shore fund structures because they are tax efficient and tried and tested investment vehicles.

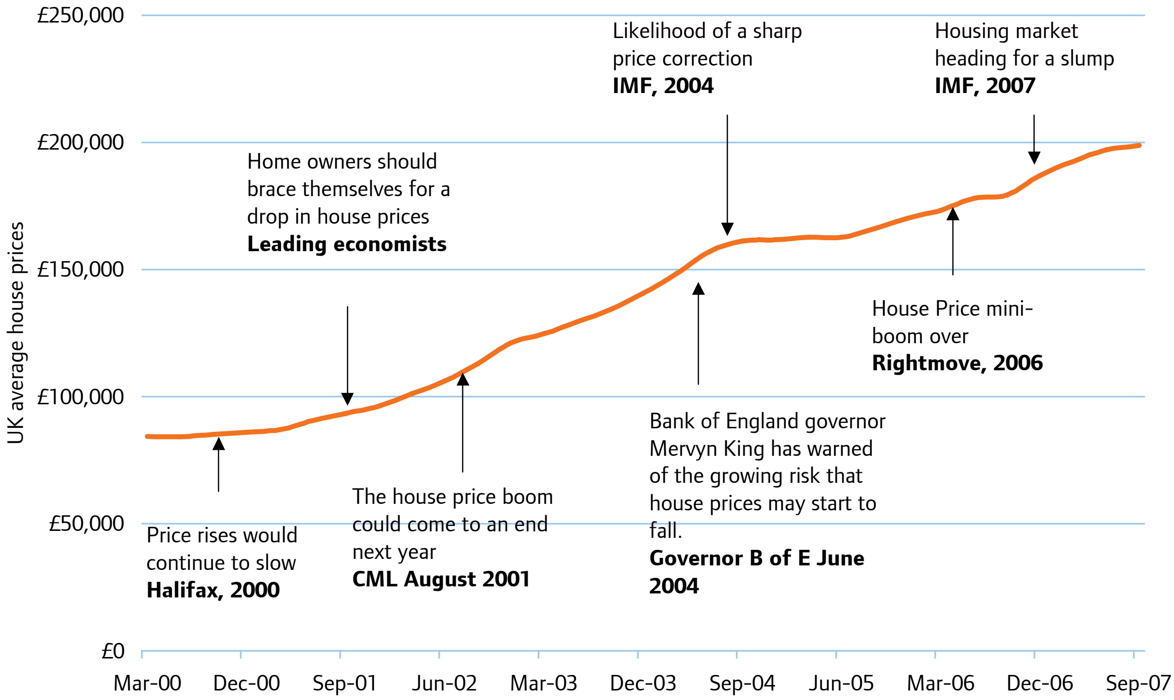
With regard to the risks posed by large numbers of consortium buyers in the UK, these investors use high levels of debt and are less risk adverse than UK buyers. 'Buy-to-let' investors in the UK have generally been limited to 80 per cent loan to value. Large-scale investors in the UK would also have much lower gearing ratios. Therefore, overseas consortium buyers are at risk from changes in residential property values in the UK but also have a number of additional risks such as changes in currency exchange rates, higher interest rates and changes in borrowing costs. These investors present more risks to the UK housing market and should any of these factors go against these highly geared investors, it could result in a reduction in the supply of rented housing.

Having a more even balance between the number of small and large residential landlords in the UK would go some way to mitigate against the risks from large numbers of small 'buy-to-let' landlords and consortium 'buy-to-let' investors.

A key factor that impacts on the investor interest in the residential sector is sentiment. As shown in Figure 3, over the last five years leading economists, banks and the Bank of England have regularly commented on the future outlook for the housing market, often presenting a pessimistic outlook for house price growth that was not borne out in the subsequent period. Despite the fact that house prices have continued an upward trend, these cautious commentators advise institutional investors on their investments. It is therefore unsurprising that sentiment towards the housing market is such an important factor.

At the current time, sentiment towards any form of property investment in the UK is very different to say five years ago. A key point is where commercial yields are and where bank debt is. As one fund manager said, 'At this particular point in time, projected returns from commercial property are low. The projected returns from house prices are probably on a par, if not feasibly slightly higher, particularly if debt is used, plus some level of rental income, then residential is looking attractive.'

Figure 3: UK average house prices



Source: HBOS, Savills

Advisors to institutional investors impact on investors' sentiment towards the residential sector.

For institutional investors a key barrier to investing directly in the residential property sector is their skill set or knowledge of how the residential property market performs. Institutions have lost the in-house skill set as a result of the large scale-disinvestment in the residential sector that occurred in the late 70s and early 80s. The only viable investment route for institutional investors today is through indirect investment vehicles, such as the property unit trust or the limited liability partnership structures described in the technical appendix. The key reason for investors to invest in indirect funds is to benefit from specialist management expertise.

Using a reputable or branded manager can also enable the investor to have an arm's-length relationship with the property, reducing reputational risks. Linking up with fund and asset managers that have a proven track record is a prerequisite for institutional investors. In recent years, residential investors that have been successful in securing institutional investment have had strong branded management organisations, such as Grainger and Unite.

Creating an investment environment that favours large-scale investors will lead to a growth in the number of branded operators of rental property.

As well as strong branded management organisations, investors require sufficient scale. For example, Unite and Grainger have 30,000 student beds and 14,000 residential units respectively, and this allows them to deliver a customer-focused service and achieve economies of scale for professional management. There is a very limited number of organisations with this scale of operation in the private rented sector. Large 'buy-to-let' investors typically have between 100 and 250 properties, which is less than 1 per cent of the size of Unite and 1.8 per cent of the size of Grainger's operation.

Residential landlords require critical mass to be able to deliver a branded customer-focused service. Generating management capacity in the sector might attract more institutional investment.

The short nature of Assured Shorthold Tenancy contracts were also identified as a barrier to families seeking to reside in the private rented sector for an indefinite period. Private sector landlords and RSLs in London identified a willingness to offer longer tenancy contracts. There need to be greater incentives to provide longer-term tenancies in the sector, so that the sector appeals to the broadest spectrum of potential occupiers and serves their needs.

Landlords in London provide longer-term AST contracts, especially at the top end of the market. Distinct rental blocks might encourage wider use of longer tenancy contracts because there is the incentive for the units to remain in the rented sector for a certain period of time.

There may also be a need for a different type of tenancy, something that sits between owner-occupation (including partial ownership) and renting. This could be a five-year lease along the line of the old 1950s-style landlord and tenant arrangement, which included an obligation to repair. It could also include a presumption of renewal of the tenancy for further five years. It would need to include an ability to sub-let to protect the tenant's interest and de-risk the rents. Renewal could be on an upwards only rent calculation that allows the cost of restriction of use of the asset to be factored in to the investment value. The asset would remain tradable with different owners (landlords) valuing the property on the basis of the unexpired term and reversionary value.

Table 3: Barriers to residential Real Estate Investment Trusts (REITs)

Institutional investors that invest in property identified that they would prefer an unlisted investment vehicle to a residential REIT because the performance of a REIT is highly correlated with the equity markets as opposed to the residential market. One respondent identified that 'from a multi-asset allocation perspective institutional investors do not need any more equities. If they required that type of exposure they are more likely to invest in a UK housebuilder that is listed on the stock market.' However, REITs are more likely to attract interest from investors within institutions' securities investment teams rather than the property teams. These investors invest in public listed companies such as Grainger or Unite and commercial REITs such as Brixton. ***Residential REITs are likely to attract more interest from equities investors than from property investors.*** For start-up residential REITs, the conversion charge is a barrier. The conversion charge was designed to attract existing UK property companies to offset their capital gains tax (CGT) liability in exchange for a lower tax (2 per cent conversion charge) by converting to a REIT. This was attractive to UK property companies that had built up large CGT liabilities, and many of the larger companies such as British Land or Brixton Estates converted. In theory, the fact that these companies were lowering their tax liability meant that their shares would be more attractive and potentially trade at a premium. However, for a start-up REIT that has not accrued CGT liabilities the conversion charge devalues the shares. For example, a new start-up REIT would be asking an investor to pay £1 for a share that was going to be worth 98p because of the 2 per cent tax. An investor is not going to pay more than the worth of an asset, whether it's a share or a physical property asset. An associated issue for the potential of UK residential REITs is that they are an income style investment. The majority (90 per cent) of the income earned by the REIT must be paid to investors and the investor then pays tax on this income received. Residential is driven by capital growth and is not a high-income producing asset.

2.4 Investment characteristics of intermediate housing

Intermediate housing includes shared ownership, shared equity financial products and intermediate rented housing. The three schemes are described in brief.

- Shared ownership is where households buy a share of a property and pay rent on the remaining part. Households can gradually buy further shares of the property (GLA Draft Housing Strategy). It is therefore an intermediate stage between the rented sector and owner-occupation where the occupier and another party co-own a property. One of the most prevalent forms of shared ownership is the government's low-cost home ownership scheme on which a rent may or may not be charged on the occupiers' un-owned interest.

- Shared equity on the other hand is a financial product that usually involves a mortgage lender and an investor that effectively provides 'mezzanine' funding[1]. The external investor participates in the upside of capital growth through increases in value of the property and/or an increase in the rental income in line with the value of the equity stake in the property or some form of indexation. Shared equity is a financial product rather than a property tenure and it can be applied to any property in the open market.

- The intermediate rented sector is sub-market rented housing that is typically provided by RSLs and housing associations, where rents are set below market levels (at a minimum 20 per cent discount).

The attraction of shared ownership/equity is that it is not management intensive. The occupier is responsible for maintenance, which reduces management costs. The shared ownership/equity sector is probably the closest to commercial-style leases of all the residential sub-sectors. It is effectively a fully repairing and insuring lease whereby the buyer (occupier) is responsible for paying all the purchase costs, the exit costs, service charge costs, and any maintenance costs. The risk of default is low and there are virtually no voids once occupied, no arrears and no maintenance costs. The only real cost to the investor is rent collection, which is deemed to be fairly marginal. Therefore, the 3 per cent gross rent is effectively a net return. From the institutional investor's perspective, income is a very important factor, and being able to accurately judge the net income return is a clear advantage of this sector given institutional investors' key aim of matching assets to liabilities.

The key characteristics of shared ownership match institutional requirements because it provides an income stream that has low void rates and management costs, and has the ability to capture capital growth.

However, to make shared ownership stack up for an investor's perspective one respondent stated that 'investors must be able to buy off a discount and achieve similar terms to a housing association.' This is because in essence the investor is providing mezzanine funding and there is a higher risk attached to this tranche of funding than to the mortgage funding.

Housing associations, particularly under Section 106 agreements, acquire a reasonable discount from VPV. Typically, they might achieve 65 per cent to 75 per cent of VPV[2] under

[1] Mezzanine finance describes sources of funding that lie part-way between conventional debt and equity funding. It can tolerate greater risks but requires greater rewards. It often has the ability to fund propositions with a higher level of risk than banks can consider, the ability to be subordinated to bank debt, to lend without security and have interest rates significantly greater than conventional borrowing.

[2] VPV is the amount that would be achieved if the property was sold unoccupied in the owner-occupied market. Occupied property is generally sold at a discount to the vacant possession value.

the section 106 arrangement. If a property is worth £100,000, a Housing Association will acquire it for £75,000 from a developer. The occupier takes a 50 per cent stake in the property valued at £100,000. This means that there is £25,000 of additional value in the property that will get sold at some time in the future. This ‘up-side’ to shared ownership would be considered attractive by investors. This model is used by the private sector with housebuilders offering discounts on shared ownership. However, there is limited product, and this model could potentially be more widely used in London.

This model becomes more attractive if the investor receives a rent for the part equity loan which can be based on up to £50,000 of value, thus releasing £25,000 of profit for the housing association to reinvest. Typically, the rent will be set at RPI or RPI+ a margin or stepped rent that encourages the occupier to staircase up and so gives the investor either an early release of capital or an enhanced return. The housing association’s notional ‘profit’ from the deal can be recycled into providing further accommodation or used to underwrite the rental income stream on the lease.

Ultimately, there is a trade-off between the security of the income for the investor and the return that the investor can expect to receive. If the housing association underwrites the rental income stream, the rent and equity can be based on a lower proportion of final value and/or lower stepped rental provisions can be written into the rental contract. However, fundamental to this approach is the ability to secure a sufficient discount to VPV from house builders. One fund manager articulated that ‘when a discount is built in as well as an element of gearing, with 3 per cent to 4 per cent rent from the occupiers, then it starts to make more financial sense’.

If the housing association underwrites the rental income stream, investors will require a lower return because the investment is considered less risky.

Table 4: Key attractions of intermediate housing

Attractions of intermediate housing	Institutional investors	Property companies	Residential investors	Fund managers
Defensive investment	✓	✓	✓	✓
Easily managed	✓		✓	✓
Low void rates	✓		✓	✓
Index linked rental income	✓		✓	✓
Potential size of opportunity	✓		✓	✓
Choice of intermediary	✓	✓		✓
Competitive return	✓			
Create sales on development schemes		✓		
Matches investor criteria	✓		✓	✓
FRI lease	✓		✓	✓

According to zone agents working in London, there are high levels of demand for intermediate rental units and low-cost home ownership schemes. The pool of demand for these products continues to expand as house prices rise. There is a clear opportunity to develop product at scale to meet the demand from investors and the demand from occupiers. Zone agents in particular criticised the fact that there is nothing available for middle income earners who cannot afford home ownership but do not fall into priority needs 'key worker' categories. This was echoed by residential investors who also recognised the need for the private rental market to fill the gap for middle income earners. However, as mentioned in 2.3 above, the lack of security in the PRS limits the ability of the sector to meet the needs of middle-income families.

Enquiries and applications for low-cost home ownership schemes far outstrip the supply and at present only those in priority groups such as key worker and public sector workers qualify. There is significant potential to expand the size of the intermediate market in London.

2.5 Barriers to investing in intermediate housing

From an investor's perspective the key barrier facing the potential growth of intermediate tenures is the issue of scale. One investor explained that 'the nature of shared ownership/equity means that it will take a long time to build up a portfolio of scale.' By retaining only a share in individual properties, an investor will require twice as many properties to get to the required fund size that would attract large-scale investors. In addition, shared ownership/equity are not mainstream asset classes and the costs involved in developing a product and marketing a product are prohibitive given current take-up rates. Due to the nature of shared ownership and the fact that buyers are likely to staircase and purchase the property outright, the sector requires a flow of stock. This was described as the 'churn of property coming through at both ends of the investment vehicle.'

One fund manager illustrated the issue of scalability with an example. An investor who has £100 million of equity to invest and leverages at 50 per cent on a loan to value basis will have £200 million to invest as shown in Table 5. If the investor acquires stock worth £200 million but only owns a 50 per cent share of the property, then suddenly the investor requires £400 million of investment stock to get to the required scale that will attract institutional investor interest. In terms of the actual gross asset value of the units, at an average value of £200,000 that equates to 2,000 individual properties. There are potentially large development sites in London that could deliver the scale of stock required to build a shared ownership/equity fund.

Table 5: Debt to equity and loan to value ratios

	Debt	Equity	Value	Loan to value	Debt to equity
Example 1	100m	100m	£200	50.0%	100%
Example 2	100m	50m	£150	66.7%	200%
Example 3	50m	100m	£150	33.3%	50%

To get to the required scale, it may require a number of volume house builders or RSLs to get together under an umbrella product to develop the scale that will attract institutional investment.

With regard to public funding and grant funded property, investors understood that the housing corporation generally favours pepper-potting of units, creating a dispersed portfolio which may be more difficult to manage from a large-scale investor's perspective. This is not factually correct and although the Housing Corporation's preference is for pepper-potting of tenures on large developments, in reality with flatted developments and because of issues around service charges, most new flatted developments have tenure-specific staircases[3] – although RSLs are happy to mix outright sale and low-cost home ownership off the same staircase.

On the basis that the Housing Corporation would require pepper-potting of units, one respondent suggested that they would prefer to invest in non grant-funded property to avoid restrictions. Restrictions are considered a barrier to investors. One respondent suggested that the reason that the Expanded Open Market Homebuy product has failed to attract interest from occupiers is because it forced people to have a choice of only four mortgage lenders and the mortgage products on offer were not the best available in the market.

Therefore, financial advisors were unable to advise potential purchasers that the mortgages on offer were best value. The scheme also required the purchaser to buy 75 per cent of the property and the equity lender could also apply an interest charge on their loan after five years. This no longer applies where the government is funding the full equity loan, but it was the case where the loan was split equally between the government and four private sector players. This meant that the product became unaffordable, especially on family-sized units, which has been reflected in the low level of take-up.

The joint partner (owner-occupier) must be able to secure the cheapest and most flexible mortgage in the market so that they can afford the rent payment.

Regardless, investors remain concerned that the rental charge on shared ownership is quite low. It is safe and secure with little risk to the income stream, but it is considered low at circa 3.5 per cent. However, the investment is a house price linked investment, so as house price inflation goes up and the occupier staircases, profit can be withdrawn from the investment, including any discount achieved at the start which enhances the return. The low-income return means that the investment does not support a high level of debt. As one respondent described, 'it's difficult to leverage aggressively unless there is expectation of high levels of staircasing'.

Investors recognise the potential of flexible tenures where the income stream is varied. This would allow occupiers to occupy on a variety of terms, dictated by their needs and circumstances. One respondent stated that 'people are becoming owners before they want or need to become owners, and they're driving people into home ownership when a much more flexible approach would be better for them.'

Institutional investors place more importance on the income component of the return and therefore shared ownership will only work where there is a rental component or a mix of tenures.

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[3] Staircasing is where a shared ownership homeowner increases their percentage share of value in the property.

The drawback to shared ownership and shared equity arrangements is that the absent owner or 'silent' partner has no control over the repair and maintenance of the property. Investors recognise that home ownership encourages occupiers to look after the property, which is a key advantage of any home ownership scheme, whether it is a financial product or a co-ownership agreement. However, if a home owner's financial circumstances change and they can no longer afford the mortgage, rent and maintenance, it is difficult for the investor to protect their equity stake. One respondent stated that 'where people are struggling financially to be in the shared ownership scheme, and they can't afford to maintain it, as an absent owner, it's extremely difficult to impose the repairs and maintenance that are required.'

Lack of control over management and maintenance is a potential barrier to private sector involvement in the shared ownership market.

2.6 Conclusions

Fund managers invest on behalf of a mix of clients including high net worth individuals as well as tax-exempt pension funds and insurance companies. Because the money can come from a variety of sources, one respondent concluded that the organisation that provides long-term rental management of property is the 'institution'.

In today's market this would include companies such as Grainger or Unite. Both these companies have been successful in fundraising for residential in recent years and are long-term providers of rental housing. Their success has been based on the fact that they have large seeded portfolios and are recognised as market leaders in their specialist areas. However, even though they are large in their respective markets, with 14,000 residential properties and 30,000 student beds under management respectively, they are still relatively small compared to commercial sectors or indeed the size of residential landlords in other countries.

In terms of value, Grainger estimated that their portfolio value is in the region of £2.14 billion (as at September 2007) and Unite's property portfolio is estimated to be worth £1.6 billion. By comparison, a large 'buy-to-let' landlord with between 100 and 250 properties is likely to have a portfolio value in the range of £25 to £60 million based on the average value of a property at £250,000.

The residential sector needs to develop more branded providers of good quality private rented accommodation that is offering decent multi-family homes. Large-scale branded providers will attract capital from a range of investor types based on their performance and will be able to offer a customer-focused service to occupiers. As they grow in size, there will be more scope for them to attract further investment, launch on the stock market and potentially launch residential REITs when they have accrued enough capital gains tax to warrant the 2 per cent conversion charge.

To encourage institutions to invest in residential property there needs to be the scale of stock, branded providers and suitable investment structures.

Structural issues in the residential market discourage wider investment in the private rented sector. The overriding barrier is the price of residential property in comparison to the rental income. Unlike other investment markets, private rented housing is not priced using investment pricing principles. In any other sector, the value of the asset is worth more occupied (ie income-producing). Added to this, the costs of transaction are high which results in a high discount applied to VPV.

One solution might be to have a stamp duty concession for properties purchased for rent, as long as they were held for rent for, say, ten years. This would effectively narrow the discount applied to VPV and potentially make new build residential more attractive to long-term landlords. In new build markets, investors require at least a 20 per cent discount to new build prices.

A more favourable fiscal environment leads to a narrowing in the discount applied to the vacant possession value of a property.

If residential property is to attract higher levels of investment and increase the supply of housing, a 'build to let' model similar to the student, graduate or intermediate markets should be developed. Respondents included in this study suggested that a 'build to let' model could be formed on the basis of a distinct planning use class or under a licensing system.

However, history has shown that restrictions on rented housing generally lead to a reduction in supply rather than an increase. Therefore, a 'build to let' model could be encouraged through the planning system where local authorities have identified a need for rented housing. Where there is an identified need within local authorities housing needs assessments, planning authorities could adopt a local development order requiring rented housing or it could be required as part of the S106 legal agreement. The rented housing provision could combine open market rented housing and intermediate rented housing that has to stay affordable for a certain period, eg five years.

If such a model followed the principles from the student or graduate housing markets, it would not attract the same levels of affordable housing or it would be delivered as part of the S106 agreement, which would make it more deliverable. Investors' motivations could be aligned more closely with the private rented sector. The attractiveness of residential to investors would be improved by addressing the following issues:

- aligning value and income more closely by less onerous affordable housing requirements
- generating investment lot size would allow economies of scale to be achieved
- creating the potential for strong covenants with branded operators
- producing a higher net income return from management efficiencies derived from design
- removing any reputational risk through arm's-length relationships.

A 'build to let' model would allow more operators to grow and become branded providers of rented housing. RSLs and large-scale managers of residential property could be accredited by a professional body such as the BPF or The Royal Institution of Chartered Surveyors (RICS).

The 'build to let' product would increase their scale and market dominance, which would have the added advantage of increasing competition between small and large landlords, and ultimately forcing bad landlords out of the sector. It would also increase the supply of long-term private rented housing and provide tenants with good quality rented housing in both the intermediate and market rented sectors.

Increasing the market share of branded operators would help lever private sector capital into the residential market.

The requirement to provide a proportion of social housing reduces the deliverability of new build schemes and reduces the attractiveness of the asset class to investors. The interest in student housing, which has seen over £2 billion of investment in the last five years, is indicative of the likely level of interest in the private rented sector, if the investment environment favoured large-scale investment.

One of the key reasons why student housing has been so successful in attracting institutional money is because of the lack of real estate investment stock in other sectors. Unanimously, institutional investors would prefer to invest in the main real estate sectors (office, retail, industrial) if the investment stock were available. This is because they understand the performance drivers, the returns are higher and more reliable, and the occupier is easier to manage. The acute shortage of commercial investment stock is one of the underlying reasons why alternative real estate sectors such as student and self-storage, are attracting institutional money.

Other residential markets that have been successful in attracting investor demand are serviced apartments and graduate housing. In both sectors, the pricing is determined by the value of the income stream. New-build stock is developed outside C3 planning use class and tend to fall within the sui generis description, which attracts no social housing and cannot be sold to owner-occupiers.

Lack of investment stock in the commercial markets is fuelling demand for alternative investment sectors including student, graduate and residential.

Another associated factor is the short-term nature of private rented tenancies. Typically, occupiers in this sector secure Assured Shorthold Tenancy contracts (ASTs) for a minimum period of six months. The short-term nature of these tenancy agreements means that tenants do not feel that they have any security of tenure. For young single professionals this may be a key driver for residing in the private rented sector. However, for families and perhaps those who are in the sector because they cannot afford owner-occupation, the insecure nature of ASTs is a disadvantage. Longer or rolling AST agreements might suit both investors and some groups of potential tenants. However, there is some anecdotal evidence of landlords offering longer AST contracts and blocks of rental units that may provide the incentive to offer this type of contract more widely.

Landlords could offer longer tenancy contracts within a 'build to let' building because the building would be for rental purposes for a limited period such as five to ten years.

A 'build to let' model should develop in areas where there is an identified need for rented housing. Structurally, the model could work if the affordable housing requirements are less onerous and where there is potential to combine the stock with other types of residential. Flexible tenures that provide a blend of income streams will attract investor interest. For example, a development could be split evenly between social, rented and open market sales. The social element could be structured under a long lease to an RSL and provide the annuity-style investment return. Private rented accommodation will provide both an income and capital return and the open market sales will provide capital receipts to fund the development (and repay debt).

There is a high level of demand for intermediate rented accommodation, especially from NHS key workers. The NHS employs a large number of people from overseas who do not qualify for mortgage finance in the UK. These key workers in particular require affordable rented housing and some level of security of tenure, especially if they are families. The tenancies will be renewed as long as the tenant retains a key worker status. If they cease to be key workers they are required to give notice on their tenancy (and their rent is raised to market rent). Long-term professional landlords also offer renewable contracts but they would offer longer tenancy contracts if they could still obtain possession of the property at certain points.

With regard to intermediate and affordable housing, housing which is designed to be flexible for occupiers will be highly attractive to investors. Flexible tenures allow occupiers to occupy the property on the terms that meet their needs. Occupiers may start off on social rent, move into private rent when employment circumstances change and from there into home ownership through shared ownership schemes.

This kind of flexibility will lead to attractive returns for investors because the structure of the return encompasses a variety of income streams. On the one hand, it provides secure, inflation-linked, and government-backed income from the social rent element. It will provide rental income from shared ownership tenures which will increase the potential for investors to use higher levels of gearing. It also provides staircasing receipts that give access to capital growth for the investors which may be reinvested in increasing the supply of housing. Furthermore, it will provide capital return from disposals that can be used to pay investors. The finances work for investors because of the nature of flexible tenures. Investors could invest in these vehicles for the returns that they require, such as split capital returns or just an income return.

A mix of rented housing will produce a blended investment return that will be highly attractive to a range of investor groups.

2.7 Recommendations

- Planning guidance and housing policies in London should promote the development of housing that is designed and built for the rental market (ie bespoke rented housing) in areas where there is demand for private rented accommodation. There is no national planning policy that deals directly with the provision of rented housing. Rented housing in London could therefore be agreed through a legal agreement such as an S106 agreement or through local development orders.

- There is a mismatch between policy requirements and development feasibility. Where there is a need for rented accommodation in London identified through local housing needs assessments, local authorities should seek a lower level of affordable housing on new developments because investors will be required to invest far higher sums of capital than under a traditional residential development model. Bespoke rented housing ('build to let') should not require the same level of affordable housing to generate sufficient levels of returns for investors.

- 'Build to let' is a development model that could be used by property companies and residential investors backed by institutional capital and should be encouraged either fiscally or through a legal planning agreement. Fiscal measures might include a tax allowance against rental costs for landlords that rent out property to remove the double taxation that they incur on management. There could be a stamp duty concession for properties purchased for rent so long as they were held for rent for a set period. If they were sold within that period, full stamp duty applies. On this basis, the rental units would remain a tradeable product (investors could sell the property and incur stamp duty) but there would be an incentive to provide long-term rental property.

- Housing policy in London should encourage the delivery of intermediate rented housing by a wider group of providers. There is over-reliance on RSLs as developers who are increasingly subsidising intermediate rented housing even where grant has been provided. There is evidence to suggest that the private sector will provide intermediate rented housing that is let at discounted market rents for a restricted period, such as five years. A reversion to market rents after a limited period is a prerequisite for investors.

- The short nature of AST contracts was identified as a barrier to families wanting to reside in the private rented sector for an indefinite period. Private sector landlords and RSLs in London identified a willingness to offer longer tenancy contracts. There need to be greater incentives to provide longer-term tenancies in the sector, so that the sector appeals to the broadest spectrum of potential occupiers and serves their needs.

- Providers of 'build to let' rented housing should become accredited landlords; any accreditation scheme should be open to long-term residential management organisations, including both private sector organisations and RSLs.

- The RSL sector is developing its skills base and capacity to manage rental property. However, until sufficient scale is assembled by RSLs, the management of their private rented accommodation is not undertaken by a dedicated team. They could potentially play an important role in providing branded management in the future backed by institutional capital as they are doing in the student sector. However, RSLs included in this research do not feel confident about drawing in private sector capital until they have established a track record in providing private rented accommodation, plus a greater understanding of how it differs from the management of their core business.

2.8 Further work

A number of investors highlighted the need to examine systems and structures in other countries. The various products of co-ownership (co-operative and condominium) that exist in the United States, Canada and mainland Europe could be replicated in the UK. The basic structure of property owned by a mutual society in which the residents have a stake can be applied to low, medium and high-income households and rented or leased products.

For example, in Denmark, there is a significant level of rented housing. Where a block or group of flats is owned by one individual landlord, should the landlord seek to trade the portfolio, tenants have the right to buy the block of flats. In these circumstances, the tenants could set up a company and purchase the freehold of the flats. The company owns the freehold and the individual flats with the tenants continuing to pay rent. Each tenant will raise a mortgage to purchase a stake the company and in some circumstances the local government will help tenants with the cost of the mortgage to buy their individual stake. The company owns everything and the tenant has a stake in the company. This seems like a rather specialist model. In effect, it is not dissimilar to leaseholder enfranchisement in the UK.

This type of model recognises that the tenants are long-term renters. This model can also work for marginal renters with rents remaining affordable and only increasing with inflation. The key advantage is that the tenant enjoys a far greater level of security. The model can be structured so that the tenants accept liability for internal repairs and have the right to make improvements which will be reflected in the market value of the property. The flat is valued on a rental basis and a higher rent will be charged for flats that are in good repair and fitted to a higher standard. The company undertakes the external maintenance and repair of the building.

This type of structure can also attract institutional investment with the institution taking a share in the company. For example, the tenants may hold a collective 49 per cent stake with the institution owning a 51 per cent stake. The institutional stake remains a tradable asset. The attraction from the institution's point of view is that it would remain detached from the running of the property and, in effect, be a silent funding partner. The rent is collected via the company and after deductions for rent collection, management and repair, the stakeholders in the company (including tenants and external funding partners) would receive a return on their investment.

3 Technical appendix

3.1 Investment vehicles

The section of the report provides an overview of the key characteristics of the indirect investment vehicles used in the UK for investing in property, residential in particular. It highlights the differences between the style of investment vehicles and the reasons why different investors use these structures. The most common types of vehicles are Property Unit Trusts (PUTs) and Limited Partnerships (LPs). The findings are based on interviews with a selection of fund managers and highlight the perceived advantages of the different investment structures.

3.2 Overview of key characteristics

There are three 'styles' of indirect property funds which determine the type of investor and the type of asset suited to the vehicle. Funds are categorised into 'styles' according to their return criteria – target Internal Rate of Return (IRR), level of gearing, and level of risk. Table 6 sets out vehicle style definitions provided by INREV (European Association for Investors in Non-listed Real Estate Vehicles). Understanding the style of the investment is important with regard to residential property. In general, residential would appear not to suit an opportunistic fund style because the asset would not provide the target rate of return and would not support the level of gearing. An opportunistic fund in residential would typically be a fund that is taking development risk as well as future capital growth over, say, a five-year period. Thus, the investment period is shorter, riskier and aiming for higher returns, of, say, 20 per cent. Table 6 sets out examples of the style of residential vehicles used in the UK.

Table 6: Style of indirect investment vehicles

		2007 INREV fund data	
	2004 INREV Definitions	**Mean target[4]**	**Standard deviation[5]**
Core			
Return	When the fund assets provide stable income returns which are a key element of the total return.		
IRR	Its overall target (post tax and fees) return is up to 11.5% p.a. or its target (post tax and fees) return is less than 1% above a specified property or peer group (usually Investment Property Databank (IPD) for property).	8.3%	2.9%
Gearing	Its permitted capital leverage ratio is below 60% of the gross asset value (GAV).	42.9%	19.9%
Risk	Core funds are seen as low-risk funds that invest in stable, income-producing assets which are held typically for five to ten years and have little acquisition/disposal activity after the fund has been invested. Assets in such a fund are typified by stable income returns with less capital growth. A core-plus fund invests in similar style assets but adopts a more aggressive management style.		

[4] The mean is the average return. To calculate the mean, add up all the values in a set of data and then divide that sum by the number of values in the dataset.

[5] The standard deviation is a statistic that is used to show how tightly all the various examples are clustered around the mean in a set of data.

Value added			
Return	Where returns are driven by a combination of income and capital return.		
IRR	Its target (post tax and fees) return is between 11.5% and 18.5% per annum or its target return (post tax and fees) is 1 to 3% above a specified property or peer group benchmark.	13.0%	2.7%
Gearing	Its permitted capital leverage ratio is between 30% and 70% of GAV.	55.3%	20.5%
Risk	Value added funds contain higher risk. The higher risk is borne from assets that often require some refurbishment, active asset management and in some cases, development.		
OPPORTUNISTIC			
Return	Where returns are driven primarily through capital return.		
IRR	Its target (post tax and fees) return is in excess of 18.5% per annum or its target (post tax and fees) return is greater than 3% above a specified property or peer group benchmark.	18.7%	3.0%
Gearing	Its capital leverage ratio is in excess of 70% GAV.	69.6%	19.3%
Risk	Opportunistic funds are high-risk in nature and can involve developments without pre-leases, acquisition of distressed assets, large portfolio acquisitions and re-packaging in smaller lot sizes. They generally have shorter holding periods.		

Source: INREV

The most common types of vehicles are PUTs and LPs. A PUT is a collective investment vehicle where the underlying properties are held on trust for the participants of the trust. While the underlying assets of a PUT are mainly direct property investments, some also invest in other indirect property vehicles.

An LP structure enables a pool of investors to invest together in one or more assets. The investment vehicle is transparent on the basis that the individual assets are not taxed, only the investor is taxed when dividends (investment returns) are paid to the investors. This is also what characterises Real Estate Investment Trusts (REITs), which explains why investors regard off-shore investment vehicles as effective REIT structures.

Both types of investment vehicles can be structured as open or closed ended funds. An open fund allows the investor to withdraw investment monies during the investment period or at specific points during the investment period such as five, seven or twelve years, whereas a closed ended fund only permits the investor to withdraw capital at the end of the investment period. Table 7 provides examples of the investment vehicles that are used for residential property investment in the UK and outlines the style of the vehicle and the type of investor they target.

Table 7: Examples of UK Residential Investment Vehicles

Style	Vehicle type	Open or closed	Target investors
Core			
Schroders ResPUT	Jersey Property Unit Trust	Open	Institutional (Pension funds)
Talbot Residential Fund	UK Limited Partnership and Jersey Property Unit Trust Feeder Fund	Closed	Institutional and High Net Worth Individuals (HNWIs)
Bridge Residential Partnership	UK Limited Partnership	Closed	Institutional (Pension funds)
Cordea Savills Student Fund	Jersey Property Unit Trust	Closed	Institutional (Pension funds)
Teesland University Capital Trust	Guernsey Property Unit Trust	Closed	Institutional
Value added			
G: RES1	Jersey Property Unit Trust	Closed	Institutional (Pension funds)
IQ Student Fund	UK Limited Partnership with Jersey Property Unit Trust	Closed	Quintain and Wellcome Trust

Source: Savills

3.3 Open/closed ended structures

The number of units and amount of money invested in a closed-ended PUT is fixed at launch. Such vehicles normally have a limited life (usually seven and twelve years). There is no obligation on the manager to redeem units as is the case with an open-ended PUT. The perceived benefits of a closed-ended PUT are that it provides a defined commitment period with a single manager and strategy. Second market trading is also available to some closed-ended PUTs, although this is subject to the appropriate market conditions.

By comparison, with an open ended PUT there is no fixed number of units or amount investment. Units can be created and redeemed depending on changes in investor demand and in line with the procedures set out in the trust deed. The perceived benefit of an open-ended PUT is that it is more liquid than a closed-ended PUT because it allows the investor to access money invested.

3.4 Property Unit Trusts

There are two main types of PUTs - authorised and unauthorised.

Authorised Property Unit Trusts (APUTs) are on-shore and are authorised by the Financial Services Authority (FSA). Although APUTs are available to all types of investor, they are designed primarily for investment by private investors (known as retail investors). However, there is also an authorised structure designed for sophisticated investors such as High Net Worth Individuals (HNWIs) and institutions. Investors in an APUT pay corporation tax on their income but do not pay capital gains tax (CGT) on any gain accrued by the properties within the vehicle. Non-exempt investors are potentially liable to CGT on the disposal of their units in the property trust.

APUTs were originally restricted to holding a maximum of 80 per cent of their assets in the form of direct property. However, this restriction does not apply to APUTs created under (or electing to be subject to) new FSA regulations published in March 2004.

The major disadvantages of on-shore APUTs is their set-up and running costs. To set up an APUT it must be listed on the stock exchange. This involves a high initial cost and it is the over-riding barrier to on-shore structures. To set up a listed vehicle on-shore the fund would have to have enough investment stock to seed a fund of circa £250 to £300 million prior to launch. This limits the ability to grow a fund when listing.

Unauthorised Property Unit Trusts (UPUTs) are generally off-shore and include a number of different structures such as:

- Non-Exempt Unauthorised PUTs
- Exempt Unauthorised PUTs
- Off-shore PUTs.

Although they can be on-shore they are generally off-shore and they target institutional investors. Whilst the operator/manager of the fund will need to be regulated by the FSA, the fund itself will not be subject to the regulations set down by the FSA. Accordingly, the fund may be run with more flexible investment objectives and restrictions to meet the investment needs of more sophisticated investor groups.

UPUTs are intended to provide a tax efficient method for tax exempt investors such as pension funds and charities to gain exposure to the property market without the management burden and illiquidity of a direct holding. In contrast to APUTs, on-shore UPUTs are not subject to the FSA regulations relating to collective investment schemes (although the operator/manager must be authorised by the FSA). They can thus be constituted to meet investment requirements of more sophisticated investors.

Non-exempt unauthorised PUTs are available to both exempt and non-exempt investors. Their income and capital gains are subject to tax at the basic rate of income tax. However, the distinction is that exempt investors are able to reclaim the tax incurred by the trust. Non-exempt investors are subject to tax on the gross amount of the distributions they receive from the trust. The tax paid by the trust is fully creditable pro rata to their holding to offset this liability. Non-exempt investors are also potentially liable to CGT on the disposal of their units in the trust. Transfer of units are subject to stamp duty at 0.5 per cent.

Exempt funds are investors such as UK pension schemes and registered charities that are not subject to CGT other than for reasons of non-residence. Exempt PUTs are available for investment only by tax exempt investors. Investors can recover income tax. Transfer of units are subject to stamp duty at 0.5 per cent.

Offshore PUTs are resident outside the UK, most commonly in Jersey and Guernsey. They usually have a local manager or operator, regulated in the local jurisdiction and/or the vehicle will be set up in accordance with local regulations. They do not meet the requirements of either the EU's Undertaking for Collective Investment in Transferable Securities directive or the FSA's regulations with regard to collective investment schemes.

Like on-shore UPUTs, off-shore PUTs are not available for marketing to the general public in the UK, although they are usually available to financially sophisticated HNWIs. By reason of their non-residence, off-shore PUTs are not liable to CGT in the UK, and are normally structured to be tax transparent where revenue taxes are concerned. Non-exempt investors are potentially liable to CGT on the disposal of their units. The transfer of units in offshore PUTs does not attract stamp duty.

Briefly, two variations include the **Common Investment Funds** and **Managed Property Funds**. Both are similar to unit trusts, but are designed specifically for charities and are therefore subject to approval by the Charity Commission. As charities, they do not incur stamp duty when acquiring properties for investment, and are exempt from CGT and income tax. Managed Property Funds are similar to Exempt PUTs in operating effectively free of tax, in being unitised and being open-ended. However, unlike PUTs, they do not distribute their income and are managed mainly by insurance companies as vehicles for investment by their occupational pension fund clients.

Figure 4 outlines some of the key features of authorised and unauthorised PUTs.

Figure 4: Key features of authorised and unauthorised funds

Unauthorised PUTs (off-shore)

A unit trust established outside the UK in a jurisdiction with a favourable tax regime, usually aimed at institutional investors. The costs involved in setting up and running an off-shore PUT may be heavier than with an onshore structure, especially as management and control of the off-shore PUT must genuinely be based in the overseas jurisdiction in order to benefit from local tax treatment.

Plus

- No tax on capital gains in fund
- Effectively tax transparent for income
- Regulatory restrictions on investment and borrowing depend on country
- No public filings

Minus

- Restrictions on marketing to individuals in the UK
- Certain trusts unsuitable for insurance companies
- Must genuinely be managed off-shore
- Off-shore regulation of manager and trustee

Authorised fund - retail scheme (NURS)

A fund authorised by the FSA and subject to regulation. May invest in property and other investments. May be an open-ended unit trust or open-ended investment company. NURS replaced APUTs and existing APUTs were required to convert to NURS by 12 February 2007. Require regular redemption dates (at least every six months), NURs in practice need to keep a proportion of their investment in liquid form and therefore will not be able to invest 100% in real estate.

Plus

- Can be marketed to the public
- Can in invest in property, securities and similar investments
- No tax on capital gains

Minus

- Regulations on spread requirements, investments limits, property dealing procedures
- Borrowing/gearing limits
- Trustee and manager must be FSA regulated
- Open-ended with dates for redemption of units at least every six months

Source: Eversheds

3.5 UK Limited Partnership (LP)

UK LPs enable a pool of investors to invest together in one or more assets. LPs vary in structure but have the common feature that they have at least one general partner who has unlimited liability in respect of the partnership. The liability of the other partners is limited to the extent of their capital invested in the partnership. LPs are restricted to 20 partners unless the LP is subject to UK regulations, in which case there is no limit on the number of participants. LPs are tax-transparent, allowing the likes of pension funds and insurance companies (which are either wholly or partly tax exempt) to invest jointly with tax-paying entities such as property companies without losing their tax advantages. The limited partners may form an advisory committee, but to preserve their limited liability status must not be seen to be making investment management decisions with respect to the partnership. LPs normally have a pre-determined life span (typically 7 to 12 years), although this can usually be extended subject to the agreement of, for example 75 per cent of the partners.

Figure 5: Key features of LPs and LLPs

Limited liability partnerships (LLP)

A body corporate established under the Limited Liability Partnership Act 2000 with a legal personality separate from that of its members. Members enjoy limited liability. There is no restriction on members' involvement in management of the LLP.

Plus
- Tax transparent
- No regulatory restrictions on investment or borrowing
- Limited liability for members
- Separate entity; owning land and borrowing straightforward

Minus
- Accounts are public (although members' agreement is private)
- Not normally suitable for pension funds
- Restrictions on marketing
- May need FSA-authorised operator
- Heavy SDLT burden

Limited partnerships (LP)

A type of partnership comprising at least one general partner, who manages the LP and has unlimited liability, and one or more limited partners, whose liability is limited (provided they take no part in management).

Plus
- Flexible vehicle
- Tax transparent
- No regulatory restrictions on investment or borrowing
- Partnership agreement is private

Minus
- Operator needs to be FSA-authorised
- Restrictions on marketing
- Not separate entity; owning land and borrowing complicated
- Transferring interest cumbersome
- Heavy SDLT burden

Source: Eversheds

Limited Liability Partnerships (LLPs) were created in 2000 and are a hybrid between a Limited Partnership (LP) and limited companies. As with an LP, the liability of the limited partners is restricted to their capital invested in the partnership, and the vehicle is, effectively, tax-transparent. However, like a company, an LLP is a 'body corporate': it has to be registered with the Registrar of Companies. Unlike the LP structure, LLPs must file audited accounts. In contrast to LPs, LLPs are permitted to have more than 20 partners, making them a more suitable structure for larger collective investment vehicles.

According to selected fund managers, LPs in the UK are considered to be highly efficient on a day-to-day basis because of their on-shore status. In particular, as residential assets typically undergo smaller and more frequent changes in tenancy (in comparison to commercial property), it is more efficient to administer the trust on-shore. LPs have also been in existence for 100 years and they are therefore regarded as trusted investment mechanisms. Their structure is very transparent and they are deemed be to a straightforward and understood investment structure.

Following legislative changes in 2004, transfer of partnership interests in an LP is now subject to 4 per cent Stamp Duty Land Tax (SDLT). At the time of the legislative change, it was anticipated that many funds would subsequently move off-shore. However, a number of funds created an off-shore feeder fund (a fund which is 100 per cent permanently invested in the units of another fund), in the form of a unit trust, and are therefore not subject to the 4 per cent SDLT. Selected fund managers reported that tax transparency and lower levels of SDLT are attractive to investors in residential real estate, as returns in some areas of this asset class can often be marginal.

Table 8 provides a comparison of the main indirect investment vehicles used for real estate investment in the UK.

Table 8: Comparison of Indirect Investment Vehicles

Vehicle	Is the fund FSA regulated?	Target investor	Income tax	CGT	CGT on disposal of units	Stamp duty on transfer
APUT	Yes	Retail and institutional	Yes	No	Non-exempt investors potentially liable	0.5%
Non-exempt unauthorised PUT	No	Exempt and non-exempt institutional and sophisticated retail	Yes	Yes, but exempt investors may recover tax	Non-exempt investors potentially liable	0.5%
Exempt unauthorised PUT	No	Exempt and non-exempt institutional	Yes but recoverable	Investor is exempt	Investor is exempt	0.5%
Off-shore PUT	No	HNWIs and institutional	Tax transparent	Exempt due to offshore status	Non-exempt investors potentially liable	0% / 0.5%
LP	(In UK) General partner is subject to FSA	Exempt and non-exempt	Tax transparent	Tax transparent	Non-exempt investors potentially liable	Up to 4% (of GAV)

HNWI – High Net Worth Individuals
CGT – Capital Gains Tax
PUT – Property Unit Trust
FSA – Financial Services Authority
Exempt Funds - investors such as UK pension schemes and registered charities that are not subject to Capital Gains Tax (CGT) other than for reasons of non-residence.

Source: HSCB, APUT, INREV, Savills

4 Important note

Finally, in accordance with our normal practice, we would state that this report is for general informative purposes only and does not constitute a formal valuation, appraisal or recommendation. It is only for the use of the persons to whom it is addressed and no responsibility can be accepted to any third party for the whole or any part of its contents. It may not be published, reproduced or quoted in part or in whole, nor may it be used as a basis for any contract, prospectus, agreement or other document without prior consent, which will not be unreasonably withheld.

Our findings are based on the assumptions given. As is customary with market studies, our findings should be regarded as valid for a limited period of time and should be subject to examination at regular intervals.

Whilst every effort has been made to ensure that the data contained in it is correct, no responsibility can be taken for omissions or erroneous data provided by a third party or due to information being unavailable or inaccessible during the research period. The estimates and conclusions contained in this report have been conscientiously prepared in the light of our experience in the property market and information that we were able to collect, but their accuracy is in no way guaranteed.

Investment funds matrix

Regulatory requirements			LP	LLP	OPUT	Prop Co	JV	AUTs (Retail)	Exempt	REIT
Who can invest?		Companies	✓	✓	✓	✓	✓	✓	✗	✓
		UK pension funds, including SIPPs	✓	1	✓	1	✓	✓	✓	✓
		Life companies (non-pension business)	✓	✓	✓	✓	✓	✓	✗	✓
		Sophisticated investors	✓	✓	✓	✓	✓	✓	✗	✓
		Retail investors	2	2	2	✓	✓	✓	✗	✓
Is investment free from regulatory restrictions?			✓	✓	4	✓	✓	✗	✓	✗
Can strategic management be UK-based?			✓	✓	✗	✓	✓	✓	✓	✓
Taxation										
Taxation of income	Received by fund	Tax in fund or	✗	✗	✗	✓	✗	5	5	7
		Tax on investor	✓	✓	✓	✗	✓	✗	✗	✗
	Received by investor from fund		6	6	6	✓	6	✓	✗	✓
Taxation of capital gains	Received by fund	Tax in fund or	✗	✗	✗	✓	✗	✗	✗	7
		Tax on investor	✓	✓	✗	✗	✓	✗	✗	✗
	On disposal of interest in fund		✓	✓	✓	✓	✓	✓	✗	✓
Maximum level of stamp taxes on transfer by investor of interest in fund			4%	4%	0%	0.5%	4.0%	0.5%	0.5%	0.5%

1. Investment is permitted but tax-efficient
2. Fund may only be marketed to a retail investor by a financial advisor who considers the investment suitable
3. For a property fund there are some minimal requirements
4. Restrictions depend on country concerned and type of fund
5. The fund pays tax but the investor can claim a refund or a credit
6. No additional tax payable: investor is taxed as income is received by the fund
7. Income and gains of a REITs property rental business are exempt from tax in the REIT but income and capital gains from any other residual business are fully taxable.

Source: Eversheds

Contributors

APT – Affordable Property Trust
Close Brothers Investments
Cordea Savills
Credit Suisse
Dorrington
Fairbriar
Firstbase
GIC
Grainger Trust
Grosvenor
ING Real Estate
Invista
Morley
Notting Hill
Pocket
Prudential
Tower Homes/L&Q
Quintain

Abbreviations

AST	Assured Shorthold Tenancy
BPF	British Property Federation
FRI	Fully Repairing and Insuring
FSA	Financial Services Authority
GAV	Gross Asset Value
GLA	Greater London Authority
HA	Housing Association
HBOS	Halifax Bank of Scotland
HNWIs	High Net Worth Individuals
INREV	European Association for Investors in Non-listed Real Estate Vehicles
IPD	Investment Property Databank
IRR	Internal Rate of Return
LLP	Limited Liability Partnership
LP	Limited Partnership
NHS	National Health Service
PRS	Private Rented Sector
PUT	Property Unit Trust
REIT	Real Estate Investment Trust
RICS	Royal Institution of Chartered Surveyors
RPI	Retail Price Index
RSL	Registered Social Landlord
SDLT	Stamp Duty Land Tax
VPV	Vacant Possession Value

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Vietnamese

Nếu bạn muốn có văn bản tài liệu này bằng ngôn ngữ của mình, hãy liên hệ theo số điện thoại hoặc địa chỉ dưới đây.

Greek

Αν θέλετε να αποκτήσετε αντίγραφο του παρόντος εγγράφου στη δική σας γλώσσα, παρακαλείστε να επικοινωνήσετε τηλεφωνικά στον αριθμό αυτό ή ταχυδρομικά στην παρακάτω διεύθυνση.

Turkish

Bu belgenin kendi dilinizde hazırlanmış bir nüshasını edinmek için, lütfen aşağıdaki telefon numarasını arayınız veya adrese başvurunuz.

Punjabi

ਜੇ ਤੁਹਾਨੂੰ ਇਸ ਦਸਤਾਵੇਜ਼ ਦੀ ਕਾਪੀ ਤੁਹਾਡੀ ਆਪਣੀ ਭਾਸ਼ਾ ਵਿਚ ਚਾਹੀਦੀ ਹੈ, ਤਾਂ ਹੇਠ ਲਿਖੇ ਨੰਬਰ 'ਤੇ ਫ਼ੋਨ ਕਰੋ ਜਾਂ ਹੇਠ ਲਿਖੇ ਪਤੇ 'ਤੇ ਰਾਬਤਾ ਕਰੋ:

Hindi

यदि आप इस दस्तावेज की प्रति अपनी भाषा में चाहते हैं, तो कृपया निम्नलिखित नंबर पर फोन करें अथवा नीचे दिये गये पते पर संपर्क करें

Bengali

আপনি যদি আপনার ভাষায় এই দলিলের প্রতিলিপি (কপি) চান, তা হলে নীচের ফোন্ নম্বরে বা ঠিকানায় অনুগ্রহ করে যোগাযোগ করুন।

Urdu

اگر آپ اِس دستاویز کی نقل اپنی زبان میں چاھتے ھیں، تو براہ کرم نیچے دئے گئے نمبر پر فون کریں یا دیئے گئے پتے پر رابطہ کریں

Arabic

إذا أردت نسخة من هذه الوثيقة بلغتك، يرجى الاتصال برقم الهاتف أو مراسلة العنوان أدناه

Gujarati

જો તમને આ દસ્તાવેજની નકલ તમારી ભાષામાં જોઈતી હોય તો, કૃપા કરી આપેલ નંબર ઉપર ફોન કરો અથવા નીચેના સરનામે સંપર્ક સાધો.