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Institutional investment in housing

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GLA Economics provides expert advice and analysis on London's economy and the economic issues facing the capital. Data and analysis from GLA Economics form a basis for the policy and investment decisions facing the Mayor of London and the GLA group. The unit is funded by the Greater London Authority, Transport for London and the London Development Agency.

Contents

Summary 2
1. A brief look back at London's private rented sector 3
2. Assets, portfolios and performance 5
3. Financial Corporations 7
4 Real Estate Investment Trusts (REITs) 10
5 Build-To-Lets 11
6. Public sector: potential interventions and policies 12
7. Conclusions and recommendations 13

Summary

1. In this background paper we analyse issues around institutional investment in residential property. Specifically, we explore:

    a. Some background and history to institutional investment in residential housing; and
    b. Options available to policymakers who may want to stimulate it.

2. Housing is unique amongst 'goods', in that it is both a **service** (that is, it provides a roof over peoples' heads) and an **asset** (acting as a store of wealth, often increasing in value over long periods of time).

3. So houses potentially offer both **capital returns** (an increase in purchase price over time, even if the physical properties of the house have not changed) and **rental yield** (a charge can be levied on those who benefit from the stream of housing services).

4. The housing market in the UK – and especially in London – has seen prolific growth in the value of houses over the last 15 years. Why have institutional investors not joined in the rush to invest in residential property?

5. The private rented sector (PRS) is a key part of the housing mix in London, helping to accommodate the flexible workforce that the capital's economy needs. If one could increase the amount of large scale institutional investment in housing (as opposed to individual or family investment), the availability and quality of homes in London's crucial PRS could potentially be improved, and become a more stable and comfortable long-term tenure choice for non-homeowners.

6. Encouraging institutional investment might also have two key policy benefits. Firstly, it could help bring forward new housing supply, including intermediate and affordable housing. Secondly, it may help improve the management of large developments, compared with that in the highly fragmented buy-to-let sector.

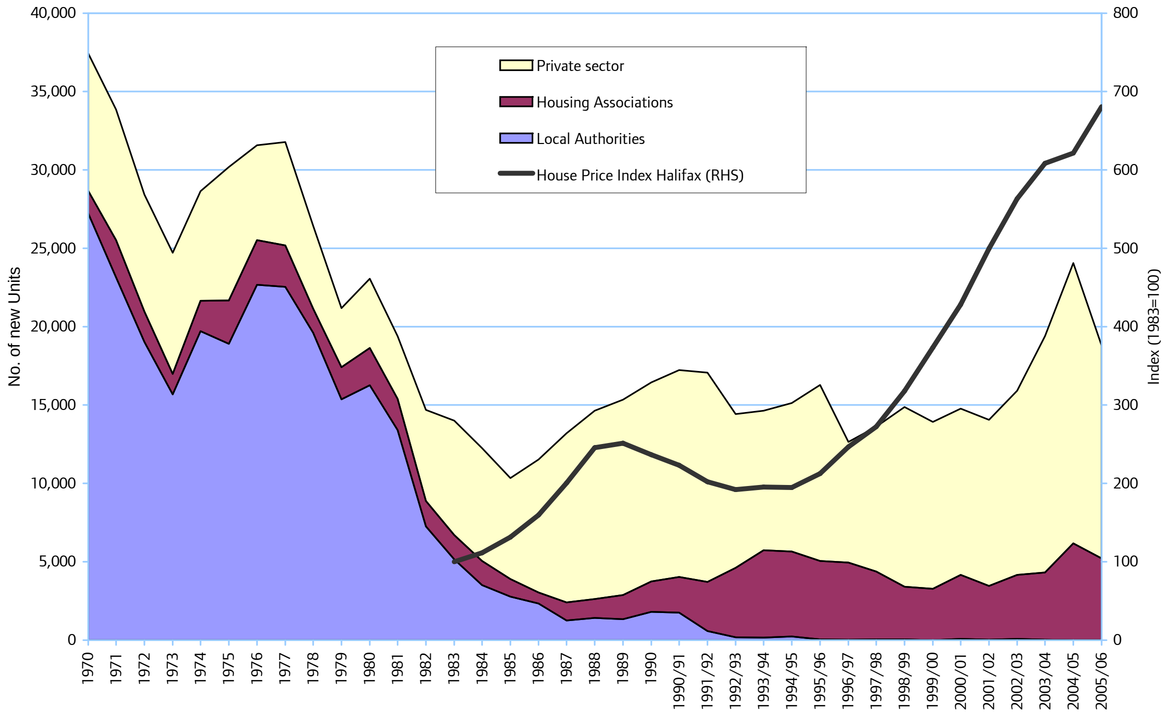
7. This background paper runs through some recent trends in London's housing market (compared to the rest of the UK). It discusses the potential importance of institutional investors, and the role of the private rented sector in London's economy. We go on to discuss the concepts of portfolio

allocation and asset performance; real estate investment trusts (REITs); build-to-lets; and the role of the public sector. We conclude with some thoughts on possible public policy responses.

1. A brief look back at London's private rented sector

1.1 London's housing market has undergone rapid change and development over the last 20 years. After a brief slowdown in the early 1990s (when some homeowners across the UK found themselves in negative equity or repossessed), residential capital values have gone from record high to record high. London's housing market has grown in both volume and value for over 15 years (Chart 1). This has been an exceptional period in recent UK history. Rarely have homeowners enjoyed such rewards – nor have aspiring homeowners been faced with such high barriers and challenges.

Chart 1: Housing completitions and house price index

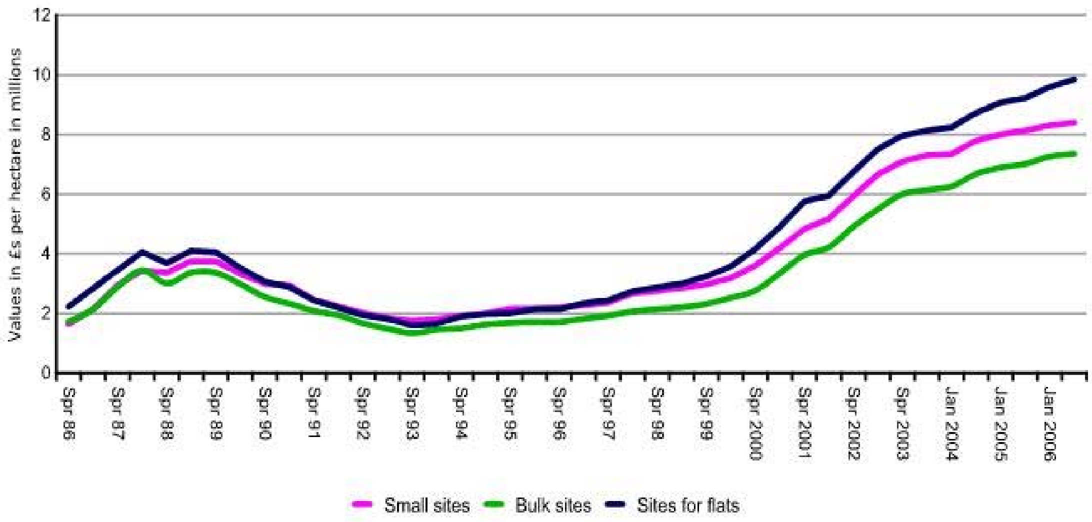


Source: CLG Live Table 232 & Halifax House Price Index

1.2 Following the Thatcher Government's policies of the 1980s, private homeownership increased through the right to buy scheme, which allowed council house tenants the option to purchase their home from their Local Authority. At the same time, the public sector house building programme was scrapped. Registered social landlords (RSLs) have expanded their building programme since, but they have not replicated the level of output from the old council housing building programme.

1.3 Growth in owner occupation was also spurred on by rent control which, between the 1960s and 1980s, made private housing less attractive for some investors. Affordable housing in recent years has been increasingly driven by 'Section 106' agreements, requiring lengthy negotiations between planners and developers. All the while, land values (Chart 2) and construction costs have increased.

Chart 2: Residential building land value in London



Source: Valuation Office Agency

1.4 Sixty years ago, renting from a private landlord was a prevalent tenure choice in London. Homeownership seemed not to be something that the majority of people aspired to, and homes would often be let out for many years. The private rented sector was dominated by large institutions (for example, insurance companies such as Prudential and Sun Alliance) who built and owned blocks of flats. Most of these were then sold and broken up after the introduction of short-hold tenancy law and rent control.

1.5 Now, the position of the PRS is quite different. Analysis of London's housing 'submarkets'[1] showed a positive correlation between the percentage of private rented homes and the percentage of people aged 20-29 years. This enforces the view that PRS caters, in part, to the young, mobile, highly-skilled and international workforce in London's service-driven economy. People are attracted to London at the beginning of their careers (before they have young

[1] Working Paper 7: Defining and Analysing London's Housing Submarkets – GLA Economics, April 2004

children and seek to move to more suburban/rural areas). They are typically looking for excellent transport links into Central London, a safe and clean environment and an excellent offer of retail/bars/restaurants.

1.6 Private rented provision for these young, relatively mobile and affluent groups is an important part of London's economic dynamism. However it is not the full story of the private rented sector in London. Hometrack estimate that nearly half (47 per cent) of the current demand for private rented property comes from what is termed the 'intermediate market' – those who do not qualify for state-supported funding, but who cannot afford homeownership. This is set to grow further – 33,000 new renting households will need to find accommodation *each year* up to 2021.[2] And this could be an underestimate – as net migration trends are uncertain. The projections of the number of new households take account of increasing life expectancy, household restructuring through divorces and separations as well as projected net migration. The PRS also houses increasing numbers of homeless households in temporary accommodation. Whatever the eventual outcomes, without major changes in public policy, the successful housing of these new flows will not be achieved.

1.7 Despite healthy demand for rented homes (and healthy incomes to pay for it), institutional investment in the sector has been low. Given the potential gains from investing in residential property, it seems surprising that more large, institutional investors have not become involved.

2. Assets, portfolios and performance

2.1 A crucial definition to clarify is the dual role of housing, as both an asset and a service. To the owners of property, rising capital values (purchase prices) mean that owners can choose when to sell and realise potential profits (or losses). Property prices (at least over recent years) have risen even without investment in the stock. In those circumstances, an investor in property can sit on their asset without combating physical depreciation – or even filling it with people – and see significant capital returns.

2.2 Housing is also a stream of services. It provides warmth, security, space and much more to everyone. A homeless person is critically impoverished. The vast majority of people live in homes and enjoy the benefits from having a roof over their head.

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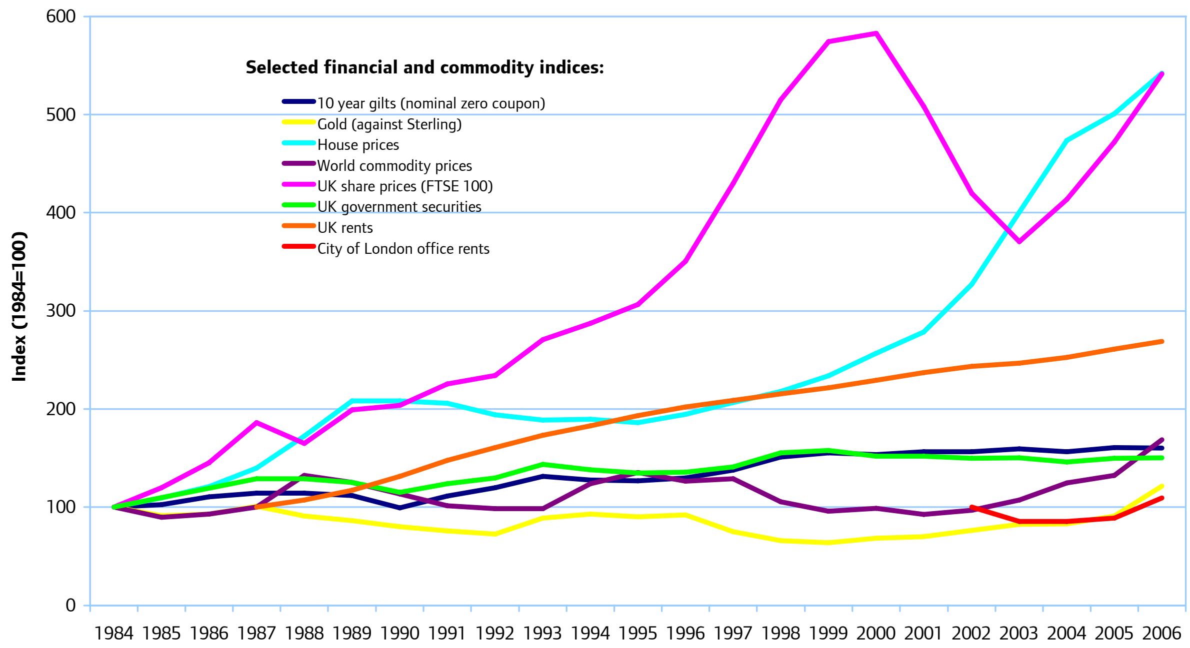
[2] Data Management Analysis Group (DMAG) - GLA

2.3 Homeowners can lease out the benefits of their housing services to others, through rental agreements. The rent covers the value of the housing services provided (that is, it should reflect the size and quality of the house, and its location) and also the extra costs faced by homeowners (often, mortgage interest costs and maintenance and management charges).

2.4 Comparing a house to a share in a company, the capital return on a house is equivalent to the capital return on a share – the change in price over time. The rent paid to live in the house can be (broadly speaking) likened to the dividend paid to the owner of the share. Dividends reflect the activity of the capital, the profits made by the company, which can be distributed back to shareholders. The crucial difference between a share and a house is that in the former the value of the share is determined by its dividend yield and expectations of future dividend yields. In the case of property, the value is chiefly determined by the highly complex and unpredictable owner occupier market – *not* the investor market.

2.5 Compared to other potential investment goods, housing has performed remarkably well (Chart 3).

Chart 3: Performance of various investment products



Source: Ecowin, Bank of England and Halifax

2.6 A question may well then be – why have institutional investors (such as insurance companies and pension funds) not invested more heavily in residential property? Portfolio allocation is a complex decision, but it would appear that (even after allowing for associated risk factors) housing suffers from under-investment.

2.7 Different investors seek different things from their investments. Often, investment portfolios are designed so that different assets provide different investment returns. For example, the 'consumption capital asset pricing model' shows that assets which co-vary negatively with stock prices as a whole tend to be worth more than other assets, as they provide security against general market risk.[3] It is commonly suggested that property can – at certain times – negatively co-vary with the FTSE. Investors often seek to diversify their portfolio (holdings) of stocks and shares, to have interests in (and share in the risk of) different industrial sectors and asset classes. A typical portfolio might include shares in financial companies, shares in commodities (including gold and base metals), shares in UK non-financial companies, an emerging markets mutual fund, futures (contracts based on the *future* prices of an asset), long-term and index-linked government bonds and corporate debt.

2.8 Residential property holdings within a portfolio tends to diversify risk as housing property has a low correlation with commercial property as well as the classic asset classes. In addition many empirical studies have argued that residential property provides a more effective hedge against inflation than shares and bonds. This is mainly due to the fact that over the long term, rents are correlated with average earnings, which normally trends above RPI.

2.9 Considering the relative benefits from diversification and growth in the property market, this paper goes on to explore the question w*hy do institutional investors not play a bigger role in London's residential property (and specifically the PRS)?*

3. Financial Corporations

3.1 While buy-to-let (BTL) investment has boomed over the last decade (since the introduction of BTL mortgages in particular), institutional and corporate landlords' share of the market has declined. According to the Survey of English Housing, the split in total landlords was companies/organisations (50 per cent) and individuals/couples (47 per cent) in 1994, but the relative shares had shifted to around 33:66 per cent by 2003. However the overwhelming majority of all buy-to-let investment in new homes is by private individuals, often with just one

[3] There is a huge literature on asset pricing, and in particular C-CAPM. See, for example, 'Asset Pricing' (2001) by John H. Cochrane.

or two properties. Recent research suggested that institutional investors account for just 4.5 per cent of new homes sold in the year to June 2006.[4]

3.2 One of the largest stumbling blocks for investment in residential property is that the institutions are priced out of the market by both owner-occupiers and BTL investors. Owner-occupiers make up the majority of purchasers of residential homes in the market and they value property in different (and often more intangible) ways to investors. Families will be prepared to pay more for homes in close proximity to good schools if they have young children. Owner-occupiers may also value amenities (open spaces, transport) more highly than investors. Additionally, small-scale BTL investors may not fully price in the management and opportunity costs associated with running a rental property. So it appears rational for family owner-occupiers, and in some cases BTL investors, to pay more for this type of house than any institutional investor.

Residential property also suffers by its comparison with commercial property. As the British Property Federation (BPF) points out in its pamphlet 'Encouraging Institutional Investment in the Residential Sector', in 2005 only around £1 billion was invested in residential property in London, while £67 billion was invested in the commercial property sector (the majority in London). The reasons for this are complex but in 2005 the average total returns from commercial property were over 19 per cent, compared to around 8 per cent for the residential sector (with even lower returns in London).

3.3 Capital returns and rental yields vary over time (Chart 4), and from location to location. However, on average, commercial properties have high and relatively stable returns, and have yielded 8 per cent higher returns than the FTSE itself. Residential property is not a substitute for investment in commercial property, but it could be a powerful complement to it (and other asset classes) in many major institutional portfolios.

3.4 What is clear is that large institutions tend to shy away from residential property for a variety of reasons:

3.4.1 Residential property is seen as a 'political football'. Although the Government has made it clear that it sees a well-run private rented sector as an important part of the housing mix, MPs and councillors are often seen to be 'anti-landlord'.

[4] London Development Research, *Who buys new market homes in London?* December 2006

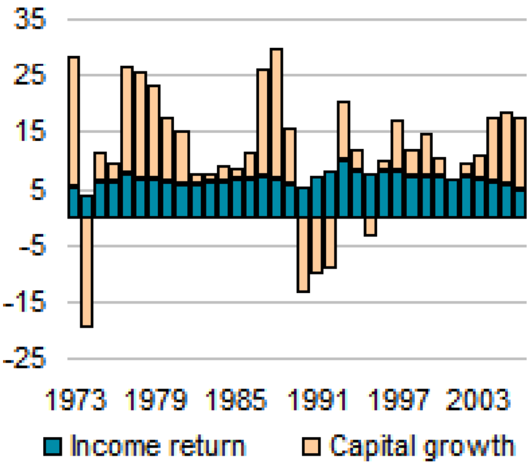
3.4.2 The approach to regulation in this area is seen as heavy-handed and inconsistent. Costs that fall on landlords are not always applied to the owner occupation sector.

3.4.3 Dealing with peoples' homes seems to have a higher risk of negative publicity than investing in their workplaces or infrastructure.

3.4.4 Management of residential property is seen to be labour intensive, or expensive to run (meaning a professional operating and management company is involved). Management and maintenance costs affect potential returns whereas with commercial property the tenants are largely responsible for such costs.[5]

3.4.5 Institutional investors prefer to have larger concentrations of units, which is offered in the commercial sector, unlike the wide dispersion of residential property.

Chart 4: Commercial Property Income Return and Capital Growth



Source: Investment Property Databank

3.5 The BPF also assert that interested investors 'face a significant challenge in obtaining suitable investment stock', and have to compete with owner-occupiers and buy-to-let. Competition for 'bulk' sites is fierce. However, the BPF are optimistic. They believe that the gap between residential and commercial property returns may have reached a peak. Real Estate Investment Trusts (REITs) may become more residential-friendly. Commercial property is also becoming

[5] The flip-side of this is that commercial property suffers from large depreciation in its lease lifetime – often moving from a Grade A to a Grade B property, thereby reducing future rental income.

scarce. And finally, in London, several large-scale residential schemes are being developed, which should be more conducive to institutional investment.

3.6 So, although institutional investors still play a relatively small part in London's residential property market, the potential exists for the sector (primarily financial corporations) to increase their role and increase the size and quality of London's housing supply. The public sector, however, has to provide a sufficiently favourable regulatory and fiscal framework for this to happen. We shall explore this further in Section 6.

4 Real Estate Investment Trusts (REITs)

4.1 REITs were introduced in the UK on 1 January 2007 in response to the Barker Review of Housing Supply (2004), which suggested that greater institutional investment should be encouraged in the private rented sector. Initially developed in the 1960s in the USA, a REIT investment structure is now in place or being developed in over 23 countries.

4.2 REITs provide a vehicle for property investment to enable individuals to avoid the hassle of buying physical bricks and mortar with initial minimal outlay. The investment process is made more liquid through the 'pass–through' organisation (REIT company) allowing quick and easy access to funds. It will also allow investors to generate returns from an asset class they would not previously have had access to in a tax-neutral environment. The risk of this investment can be spread across geographic boundaries and between commercial (retail, office and industrial) and residential portfolios.

4.3 One of the major advantages of REITs is their tax efficient nature for both the REIT company and the investor. The REIT company buys, sells and develops property assets – and then distributes the majority of its cash flows to investors as it is exempt from paying corporation tax. Further the capital growth and rental yield from the properties go untaxed (although, note, capital gains are taxed if they are distributed to the share holders rather than re-invested). Investors can avoid paying tax on the dividends they receive if they hold their investment in a tax efficient vehicle such as an ISA or a pension.

4.4 The introduction of REITs will impact on the tax revenue received by the government and as a consequence the Treasury will impose a one-off 2 per cent tax on the value of all property holdings by the company on conversion. Legally, a REIT must hold at least 75 per cent of its total investment portfolio in qualifying property and distribute at least 90 per cent of its net rental income to investors (in the form of dividends). This reduces the amount of potential profit for the investor.

4.5 The global value of REITS increased 27.5 per cent from $505bn in 2004 to $660bn in 2005[6]. The growing importance of this investment vehicle is reflected in the widespread adoption of REITs by European countries including France and the UK.

4.6 So far, REITs have been concentrated in the commercial sectors. In the USA, only 21 per cent of REITs were residential in 2001[7]. The first 9 UK companies that converted to REIT status on 1 January 2007 have mostly commercial property holdings. Discussions are taking place with Registered Social Landlords in the UK around the option of converting part of their market rent and shared ownership properties to REIT status. Invista, the property fund management business, has recently been seeking support from investors for the first residential REIT in the UK.

4.7 One of the concerns expressed by financial commentators is that investments in REITS could leave individuals exposed to the risk of weaker property prices if they hold a large proportion of their assets in property. REITs will also be subject, to some extent, to the volatility of stock markets and financial prices in general, as they will be listed on a major stock exchange (although the extent of this relationship is not clear from overseas experience).

4.8 Research undertaken by Henderson Global Investors plc suggest that the market share of residential REITs in Europe is only 5 per cent compared to those specialising in retail, industrial and offices which account for just over 70 per cent. This share is unlikely to grow in the UK as the converted companies have few incentives to introduce residential REITs (mainly due to lower yield returns). In some other countries, such as Germany, residential REITs are explicitly banned as they already have other structures for holding residential property.

5 Build-To-Lets

5.1 One immediate way to increase the amount of investment in new housing stock is to facilitate the 'build-to-let' market. Build-to-let can be as small-scale as a potential buy-to-letter deciding to build the property themselves, or as large-scale as a developer building a several hundred-unit site and keeping the properties under their own ownership/management. This provides the

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[6] UBS Global Asset Management Research

[7] NAREIT Q1 2001

investor with a measure of direct control over the future of their property. However, these companies (whose aim it is to create a shareholder value) face building a product which is devalued the moment a tenant moves in.

5.2 The advantages of build-to-lets are that (with few exceptions) they tend to be better managed than sites under multiple ownership which can have as many landlords as housing units. The developers, in some cases, can act as agents to more remote landlords. For example, the build-sell-manage model of Ability Housing (which recently was bought out by Grainger Trust) and Cheval supports this proposition. Of all new built private sector homes in London, 9 per cent are build to let – 6 per cent private developers, 3 per cent registered social landlords (RSL's).[8]

6. Public sector: potential interventions and policies

6.1 Despite the decline of council housing in the 1980s, the public sector still plays a major part in the provision and management of housing in London. It fulfils its obligations through the Housing Corporation, English Partnerships (now merging to form 'Communities England'), local authorities themselves and regional bodies such as the Greater London Authority. But even within local authorities themselves, the housing and planning departments may sometimes not work effectively together.

6.2 Increasingly, the public sector's role is moving away from direct provision towards funding private sector (including not-for-profit) bodies and providing the regulatory and legal environments for the different agencies to operate within. The public sector also provides a crucial planning and strategic role – increasingly concentrated under the Mayor of London. These policies have all evolved over several decades and include negotiations over the proportion of affordable housing on new developments, commitments to mitigating climate change through decent standards of homes and planning to create sustainable mixed communities. Local boroughs also have their part to play in providing social housing and ensuring they have clear planning objectives set out in their Local Development Frameworks.

6.3 One option, being explored by individual institutional investors (including some members of the BPF) is 'Affordable Property Trusts' (APTs). An APT is a type of unit trust – a collective, on-going investment vehicle, split into equitable units and founded under a trust (a legal agreement). Unit trusts can be run under any number of purposes, using a multitude of

[8] Who Buys New Market Homes in London – December 2006 - London Development Research

different trading strategies. The purpose of an APT is to be a 'socially responsible' investor in affordable housing (defined as social rented units, shared ownership units and discounted market rent units).

6.4 APTs have been set up by specialists in financial services and affordable housing. The GLA's London Plan team has been advising on their obligations towards meeting GLA planning policy. Importantly, APTs are open to large occupational pension schemes for UK and European companies. These pension funds require long-term investments providing steady streams of income – to match their long-term liabilities.

6.5 The prospect of APTs has been widely supported by a range of public and private sector bodies. The investment vehicle could increase housing affordability, recycle benefits back into the supply of more affordable homes, and also act to increase the 'eco-friendliness' of developments.

7. Conclusions and recommendations

7.1 This paper has introduced the issue of investment in the PRS, and specifically the potential role of institutional investors. Given the decline of public sector house building, it is imperative that the quantity and quality of private rented stock in London is both maintained and enhanced. GLA Economics believes that institutional funds could play a key role in this regard – and will explore the role of both affordable housing trusts and REITs further as well as examining other potential models.

7.2 William Hill of Schroeders outlines a ten-point plan that neatly summarises the factors that, he argues, should be addressed in order to attract institutional capital into residential property. These are summarised in Table 1 along with the potential influences of the GLA group.

Table 1. Attracting Institutional Capital – 10 Point Plan[9]

10 point plan	**GLA Direct Powers/Levers**
Get Residential into the property benchmark	The GLA does not provide any Index monitoring the performance of commercial or residential property.

[9] The Smith Institute – More Homes to Rent - http://www.smith-institute.org.uk/pdfs/homes-for-rent.pdf

Ensure political consensus on key policy issues	The Mayor's Housing Strategy will set out the strategic position for London. The strategy will be adopted by all London boroughs and will set out clear guidelines around the expectations for housing supply, decent homes, design quality, eco-standards and creating sustainable communities.
Remove stamp duty penalty on large investors (1 per cent rather than 4 per cent)	The GLA could potentially influence government to reduce stamp duty charges on investors or to waive them all together, subject to sound evidence and justification. This will be based on research and perhaps international comparisons of areas where this kind of action has stimulated greater delivery.
Reduce the VAT drag on performance	Similarly influence government to reduce the VAT burden on residential property investors, as this is a disincentive for large institutional investors to buy residential. Commercial property does not face this same VAT cost.
Decouple investment values from a percentage of vacant possession value	Influence the Royal Institute of Chartered Surveyors (RICS) to consider valuation issues
Invest in imposing a residential investment index	The GLA will not create an investment index but can encourage other data companies to consider this. The Investment Property Databank (IPD) is one potential provider.
Ensure suitable investment vehicles are available for investors	The GLA is currently talking to the BPF on the use of Affordable Housing Trusts as outlined in this paper. There are other similar initiatives that should be looked at.
Sponsor an independent research paper to examine the long-term beneficial investment characteristics of the sector	Perhaps the most important point. A piece of research that clearly outlines the long-term benefits of investing in residential property, as well as the possible risks, will provide greater confidence to investors – again, the GLA and BPF are working jointly on this.
Reward management excellence with less regulation	Influence boroughs and other planning/regulatory bodies to reward good management practice. Provide regular avenues for proper tenant feedback.
Encourage universities and property bodies to push residential investment higher up the career opportunity ladder	If there is greater awareness of residential property as an asset class then this will be pushed higher up the opportunity ladder. Perhaps the negativity surrounding residential investment is the threat of a house price crash leaving investors exposed to negative equity.

7.3 Further work will be taken forward to consider appropriate policy responses to these issues. Following the publication of the draft Mayor's Housing Strategy, work will focus on the delivery plan. The GLA is open to exploring all potential avenues for increasing both the quantity and the quality of homes across all the tenures.

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