No place like home: investing in residential property

By Chris Panteli

Institutional investment has long been the life-blood of the UK's commercial property sector. But despite our ongoing obsession with owning our own homes, the exposure of pension funds and insurance companies to residential property is negligible. Just 1% of the UK's housing stock is owned by institutions, compared to between 10% and 15% in most European cities.

There are several clear reasons why British investors have yet to move in on the residential market, but a heady combination of favourable regulatory changes and a lack of income from traditional sources suggest this is slowly but surely changing.

"I think funds have been talking about going into residential for quite a few years now, but none of them have actually necessarily jumped in to it," says PRUPIM senior research analyst Emma Harding.

"Partly there's always been a lack of transparency around what's been going on in terms of performance. IPD launched their Residential Index a few years ago now, but before that there wasn't really anything which could necessarily tell investors how the market was performing, what rental levels were, what the net to growth costs were, and that side of things."

Another stumbling block has been income. While capital values have skyrocketed in recent years, rents have failed to keep up. And out of these low yields owners must spend a significant sum on management fees – an additional cost not found in commercial property.

A hands-on approach

"Generally residential is a low income returning asset class," adds Harding. "If you look at it I think all property income return is about 6% to commercial property and that compares to an income return of, perhaps even nearer 3% or 4% for residential. So that's one mayor deterrent to start with.

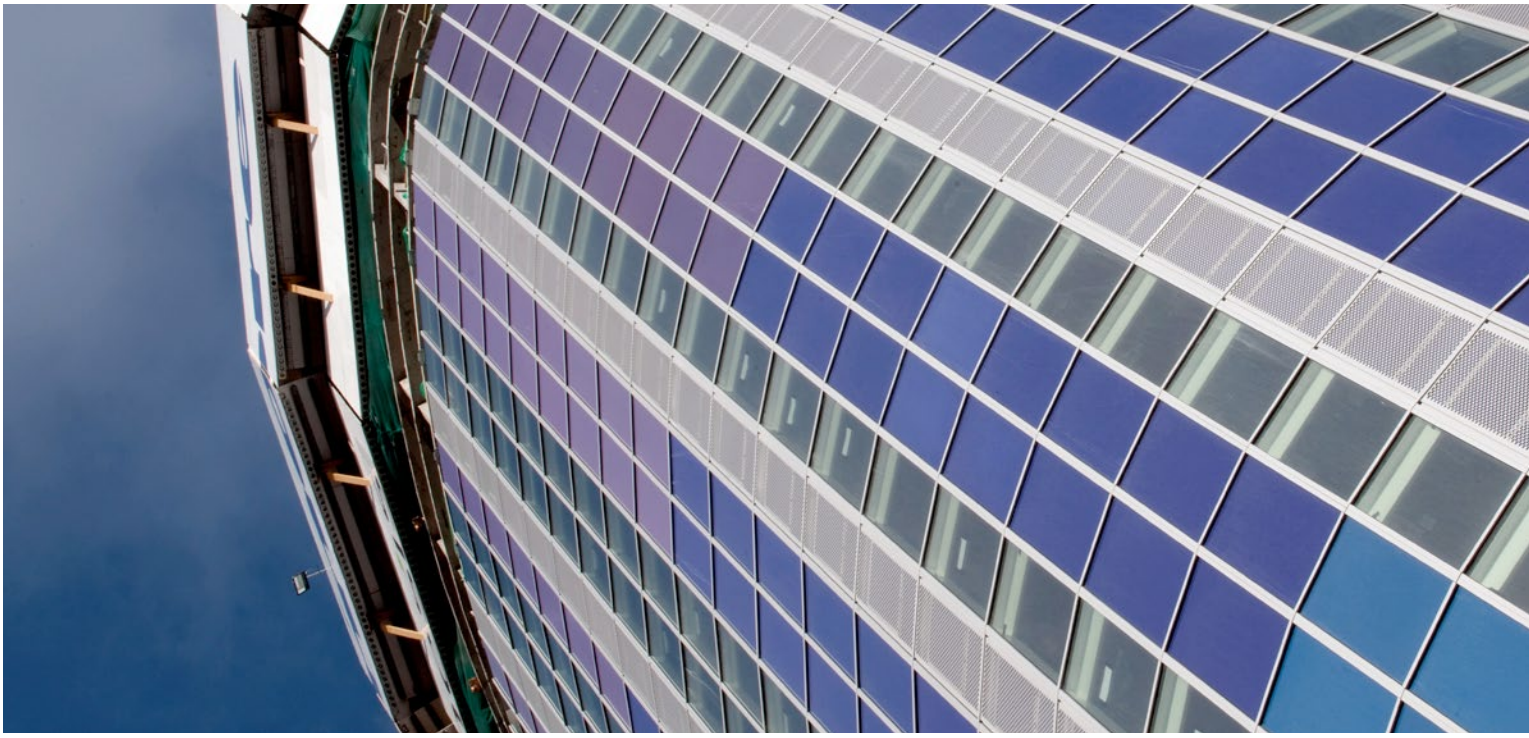
"Part of the reason as well that the income return is so low is because, obviously, residential is a very management-intensive asset class. I think the rule of thumb is that the growth-to-net ratio for residential is about 30%, so you're losing 30% income just on management and maintenance costs."

Mayfair Capital chief investment officer James Thornton agrees: "It's a very different model to commercial because residential is absolutely hands-on, which is why you need the management infrastructure.

"The commercial market has tended to be five, 10 or 15 year leases, the tenants look after the building and you get a relatively high yield. The problem at the moment for a lot of the commercial market is you're not getting any rental growth because the economy is flat-lining."

But while residential property may once have struggled to match the income gained from commercial, a broader comparison of asset classes suggests it is a good diversifier and an attractive bet. At the end of last year, Islington Council hit headlines when it allocated £20m (2.5%) of its £810m pension fund to residential property, becoming one of the first UK schemes to do so.

Explaining the move, Islington Councillor and pensions sub-committee chairman Richard Greening said: "If you compare the housing market to equities over the last 10 years it is a no-brainer; the housing market did correct in 2008/9 but has shown strong growth the rest of the time. It strikes me as mad to ignore this sector." *(see box-out on p33 for more)*.



However, as the need for more rental property is becoming ever greater, deals are being made which see the investor divested of management responsibility, such as the agreement struck by M&G Investments when it acquired the Stratford Halo, 43-floor residential development at the main entrance to the Olympic Park in East London in January. As part of the deal M&G paid £125m for the property before leasing back the 401 apartments to housing association Genesis. The lease will see Genesis making rental payments for 35 years that rise annually in line with inflation (RPI). The association will also be responsible for sub-letting the properties to residential tenants and on-going management of those tenancies, including all outgoings, maintenance and repairs. The purchase was the first residential investment by the £1.5bn M&G Secured Property Income fund, but another block is already in the pipeline.

"I think generally the issue for pension funds is that they don't have the capability [to manage the property], and therefore direct investment into residential has been quite problematic," says M&G Secured Property Income fund manager Ben Jones. "What we did here is essentially split up the transactions between us and our investors and Genesis; that left each party with the pieces they were best at and which were attractive to them, and left them without the bit they didn't want. From our investors' perspective it's given them a long-term ownership interest in London residential real estate, which is attractive because people feel there are good long-term growth prospects out of that. It also gives them a 35-year index-linked cash flow stream, which is incredibly attractive to pension funds. Any sort of long-term index-linked cash flow is like gold dust to pension funds."

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The burgeoning rental market

In addition to innovative solutions to the management hurdle, other changes have made the sector more appealing to investors. Perhaps the most obvious reason for the new-found interest in the asset class is the huge growth of the private rental market, spurred on by drying up of lending to first time buyers.

The proportion of owner-occupier households in England has fallen from 70% in 2001 to 66% in 2011, the lowest level since the late 1980s, while the proportion of private renters has risen from 10% to 16.5% over the same period. Some 3.6m people in England now live in private rented accommodation and that number is set to rise significantly over the next few years.

"I'm in my early 50s, and was able to come to London in the early '80s and buy a house with a friend and get quite a big mortgage," says Thornton. "That's gone. The average age of somebody getting a mortgage as a first time buyer, unassisted by parents, is now 37 and I think with the banking conditions as they are, that's going to continue – certainly for the next five years."

With renting on the rise – particularly in London – the government is looking for ways to build more homes, and as with its infrastructure plans, hopes institutional investors can supply the funds necessary.

In a bid to house this growing army of private tenants, the government last year commissioned Sir Adrian Montague to look at ways of increase housing stock. Published in August 2012, his report recommended that institutional investors could fund large-scale building of private housing specifically for rent. The findings were broadly welcomed, with the British Property Federation saying the recommendations "could unleash unprecedented investment in house building from pension funds, insurance companies and REITs [real estate investment trusts]".

"Encouraging institutions into building homes for rent has for some time been seen as the holy grail in enabling a long-term, private rented sector which is designed and built to let and offers renters something a bit different in the marketplace," said chief executive Liz Peace.

Meanwhile, changes to the way stamp duty is calculated on housing blocks has made it far more investor-friendly. "Previously if you bought a £20m property you would have paid 4% stamp duty on £20m," says Thornton. "Under the new rules you now divide the £20m by the number of units and take the average unit size and pay the stamp duty on that, which is much friendlier."

A 'chicken and egg' situation

However, while many of these stumbling blocks have been eliminated, one of the biggest barriers to institutional investment is a lack of suitable housing stock. Purpose-built apartment blocks simply don't exist in the way they do in the US and mainland Europe, leaving new-builds as the only realistic option. And therein lies the rub: investors are only interested in new-build apartment blocks, but without investment not enough new-build apartment blocks can be built. "That's always been the problem," Harding explains. "You're not going to get the stock until investors start investing. But you're not going to get the investors until you get the stock."

Jones agrees: "I think there are opportunities, but it probably is a little bit 'chicken and egg'. I guess our hope is that transactions like [Halo] can be a guide as to how this can be done and how that investment can be brought into the sector."

So while much has been done to open the door to institutional investors, there is still some way to go before residential property commands the allocations its commercial counterpart enjoys. Investors, however, remain optimistic. "There is strong appetite from pension funds; it just needs to be done in a framework that they're comfortable with," says Jones. "That's what this transaction has tried to achieve, while hopefully making a positive contribution to the delivery of more housing in London and the UK."

Safe as houses

Islington Councillor and pensions sub-committee chairman, Richard Greening explains the reasons behind the fund's £20m investment in residential property.

Why did you decide to invest £20m in residential property?

It has been my view for some time that residential property was an investment class we should be invested in and we had been looking for a suitable investment vehicle to do it with. The evidence is that residential property is strong in terms of both the revenue returns and capital growth. If you compare the housing market to equities over the last 10 years it is a no-brainer; the housing market did correct in 2008/9 but has shown strong growth the rest of the time. It strikes me as mad to ignore this sector but the lack of products has been a problem. As a council we are very focused on the lack of affordable housing in Islington. We are building 2,000 new homes over this four-year term so it does make sense for our pension fund to be investing in housing.

Were there any potential concerns before making the investment?

The negatives are things like the involvement in housing management and repairs. It is also perceived to be not so liquid, but for pension funds liquidity is less of an issue because we take a long-term view. If we can't get our money back immediately it doesn't matter, because we are investing for 20, 30, 40 years. We also have investment in commercial property which was initiated about eight years ago, but we have moved into residential because we see that sector as a particular opportunity.

Will you increase the fund's allocation to property in the future?

We will be looking at the strategy when we have the next valuation. I think we should increase the investment in residential property but we want to make sure we are happy with this initial investment.