*improving living in scotland*

HOMES FOR SCOTLAND

# Building the Rented Sector in Scotland

## Attracting **new sources** of funding to expand a growing market

Kath Scanlon, Christine Whitehead,
Peter Williams and Kenneth Gibb

A Report for **Homes for Scotland** by

LSE London

Cambridge Centre for Housing & Planning Research

December 2013
www.brs-scotland.co.uk

# Table of Contents

## Annexes

# Chair's foreword

There can be no doubt that Scotland requires many thousands of additional homes across all tenures in order to meet housing need over the coming years. With our population at a record high (and set to rise further) and the number of new households formed each year projected to increase by over 21,000[1], the Scottish Government forecast that 465,000 new homes are necessary by 2035[2] to meet demand. But this is in stark contrast with new housing output which is now at its lowest level since 1947, having slumped by over 40% since 2007, and currently sitting at under 15,000[3].

However, the impact of the financial crisis means that the capacity, finances and ability to deliver these much needed homes has become extremely constrained as a consequence of the following:

- Those people who would traditionally have been first time buyers found that they were unable to gather together the much higher deposits needed to obtain a mortgage and therefore some of them looked to the rented sector for somewhere to live. Others were forced to stay with family or friends - or simply delay their plans altogether.
- Developers found that banks simply lost their appetite for lending to real estate projects leading to a dramatic decline in housing output, which now sits at its lowest level since 1947. Some home building businesses, unable to cope with these extraordinary market conditions, sadly folded.
- Some home owners who had intended to sell their properties found that the market had collapsed, with deferring any move and renting them out becoming the only viable alternative- some refer to this group as "accidental landlords".

The above conditions led to the unplanned and unexpected rapid growth of the Private Rented Sector (PRS), bringing challenges as well as potential opportunities with respect to it becoming a professionally-managed and important tenure option for many.

For some years there has been talk that large financial institutions were interested in investing in rented residential development but this has not materialised to any great effect. The Montague Report of September 2012 investigated the barriers to growing the private rented sector, raising the issue to higher levels of awareness.

Quite clearly new thinking and new approaches are required in order to translate this latent interest into activity.

Homes for Scotland (HFS) had been in discussions with the Scottish Government for some time as to how the challenges to delivery and opportunities available might be unlocked. This culminated in January 2013 with the Scottish Government and Scottish Development International (via Construction Scotland) jointly agreeing to sponsor HFS to investigate the opportunity, undertake research and, more importantly, if possible, drive actions to stimulate the growth of the sector. We are therefore grateful for their strategic and financial support with this project.

As a former chairman of HFS and current Board member I was delighted to be invited to Chair this important project.

A project steering group, which supports the core HFS project team, was assembled (led by HFS and comprising members from the Scottish Government, Construction Scotland, Scottish Futures Trust, Scottish Property Federation, Places for People and Scottish Widows Investment Partnership) which agreed the project objectives and identified the need for some expert research that was focused on the specific issues and opportunities in Scotland.

Following a tender process, the London School of Economics and Cambridge Centre for Housing & Planning Research were appointed to undertake this research. This report summarises their findings.

However, I am keen to point out that this is just a stage in the project - an important stage because the real work starts now, with the implementation of the conclusions and recommendations.

The reality is that this project is about facilitating delivery of sustainable new build homes for the professionally managed rented sector, funded in an innovative way by new sources of institutional finance to the housing market.

Gerry More

I note that one of the report's recommendations is the creation of a 'Rented Sector Champion' to take these suggestions forward. Given the importance and complexity of the task, this would seem a sensible step.

I'd like to thank all the contributors to this report and project steering group members for their input to date; their efforts and time commitments are gratefully received.

This report has provided the steering group with an excellent overview of the barriers, opportunities and some ideas as to the possible solutions. I look forward to seeing the 'fruits' of this work and the provision of more new homes to meet our nation's needs.

**Gerry More**

Chair of Project Steering Group, HFS Board Member
December 2013


Source

1. The Registrar General's Annual Review of Demographic Trends 158th Edition (17 October 2013)

   http://www.gro-scotland.gov.uk/statistics/at-a-glance/annrev/2012/index.html

2. Scottish Government press release

   http://www.scotland.gov.uk/News/Releases/2013/05/pension-funds

3. Housing Statistics for Scotland - All sector new build

   http://www.scotland.gov.uk/Topics/Statistics/Browse/Housing-Regeneration/HSfS/NewBuildAllSector

# Acknowledgements

Homes for Scotland would like to thank the Scottish Government and Construction Scotland for sponsoring this project to investigate the opportunity to build capacity in the rented sector in Scotland.

Whilst led by Homes for Scotland, the project, research and Homes for Scotland Report were all informed by a Project Steering Group comprising:

**Brad Gilbert,** Scottish Government

**Lynsey Thomson,** Scottish Government

**Rachel England,** Scottish Government

**Alastair Wallace,** Construction Scotland

**Colin Rae,** Places for People

**Neil Rutherford,** Scottish Futures Trust

**David Sivewright,** Grosvenor Britain and Ireland

**Edward Trevillion,** Scottish Widows Investment Partnership

**Angela Davey,** Scottish Development International

**Gerry More,** Homes for Scotland

**Philip Hogg,** Homes for Scotland

**Karen Campbell,** Homes for Scotland

Homes for Scotland would like to acknowledge its appreciation to each member of the Steering Group for their time and valuable input.

Homes for Scotland would also like to extend its appreciation to each organisation that supported this work by taking part in interviews and/or group discussions.

**LSE London** and the **Cambridge Centre for Housing and Planning Research** were commissioned to undertake the research on behalf of Homes for Scotland in June 2013. This report contains the findings of their work and their recommendations to support institutional investment in the rented sector.

The publication of this report does not, however, signal the end of this project for Homes for Scotland. Having led the research to conclusion, we are now keen to take the recommendations and do what we can to convert the research into the delivery of new homes on the ground.

## The opportunity

1. There has never been a better opportunity in our lifetimes to develop new models of rented housing. These can result in long-term involvement by institutions in high quality, well-managed homes for a wide range of mobile households as well as some elements of family demand. Interest and enthusiasm is high – but we still need to see fully operational schemes on the ground.

2. The objective of the project was to clarify how to help housebuilders increase the supply of new homes in the rented sector. The emphasis is on overcoming the barriers to expanding output, especially through new sources of private funding and financial models that can provide incremental net investment.

3. The starting point is that investors will only bring funds into rental housing if the risk-adjusted return they can achieve is expected to be higher than that available elsewhere. Equally, developers must see the potential for profit if they are to build. Current levels of output are low compared to requirements so something has to change: demand can increase, costs may decline, or risks – or indeed attitudes to risk – may lessen.

## Future requirements for rented housing

4. Future demand is fundamental: demographics suggest that more than 20,000 households will form each year in Scotland and this trend will continue into the longer term. Since the recession, however, output has fallen – to around 15,000 units in 2012 – and, as yet, shows little sign of revival.

5. The very significant changes in tenure since the turn of the century reflect both structural and cyclical drivers. In the 11 years from 2001 to 2011the private rented sector grew from 7% to 12% of Scotland's total stock (i.e. by about 135,000 units). Even if owner-occupation moves back towards 65% – the proportion in 2007 – Scotland will need at least 7,500 dwellings a year to be added to the rented sector.

6. New rented housing can be provided in the social, intermediate or private rented sectors. The social model is well understood and most innovations are around ways of making grant go further. Over the last few years the intermediate market has seen important developments in mid-market rental models and low-cost homeownership, both of which meet the needs of those unable to afford full market rents and prices.

7. The big gap is in investment in the private rented sector – that is, homes let at market rents by private landlords or registered social landlords through for-profit subsidiaries. The majority of the increase over the last decade has come from existing stock rather than new construction, and most new investment has come from buy-to-let landlords. However, there is now increasing interest in the potential for large-scale investment on higher density sites managed by professional landlords and financed by institutions.

## Barriers to new investment in rented housing

8. Barriers to new investment in rented housing are well-understood in general terms. The core issues are the difficulty developers have in competing for land against owner-occupation; lack of development finance; low risk-adjusted yields; lack of investor experience in the sector together with the very limited performance data on which to base decisions; the need for scale; negative investor and local government attitudes to the sector; poor quality and expensive management; reputational risk; and uncertainties around the regulatory and taxation regimes. As a result, most investment occurs in the social and intermediate rented sectors with the help of government subsidy.

9. The reasons for lack of investment can also be very specific. They include, in particular, investor mandates within financial institutions which do not include residential property and building specifications which do not meet the specific requirements of the private rented sector. Equally, the different stakeholders often speak different 'languages', even when talking about core issues such as the meaning of planning and development risk, determinants and interpretation of yield, and the implications of legislative change.

10. The vast majority of barriers do not differ greatly between Scotland and the rest of the UK. Perceived demand is heavily concentrated in Edinburgh (as is true in England with respect to London) and to a lesser extent in Glasgow, Aberdeen and Inverness. UK investors who have no experience of Scotland are unlikely to move into that market until there is evidence of success. Scale is a major issue as most Scottish builders are relatively small. And changes in legislation, even when directed at improving the investment environment, can generate uncertainties.

## Overcoming the barriers

11. Each of these barriers must be addressed directly. The solutions must clearly improve expected yields and/or lower perceptions of risks. Moreover, the result must be a coherent package; modifying individual elements without thought to other barriers can have perverse effects.

12. The most immediate new build issue is to ensure that land is available where developers will wish to provide rented housing, probably within mixed-tenure developments. Most of the mechanisms being used in England for this purpose involve the use of public land and leases and 'covenants' to ensure long-term rental. In Scotland, identifying the need for private rental within local plans is seen as important, particularly by developers, as is potential exemption from S75 for rental developments.

13. The lack of private finance for development is seen as particularly problematic. Ways forward include involving investors (including institutions and housing associations) at a much earlier stage or, as in England, perhaps introducing a form of market-priced but government-sponsored Build to Rent Fund that covers the development stage.

14. There is often a mismatch between the scale of development and the desired scale of investment. Ways forward include the use of intermediaries to aggregate up to the required scale.

15. Investor attitudes are affected by their lack of experience and expertise in the sector and the paucity of data available to provide the necessary empirical basis for decision-making. To the extent that senior management sees important opportunities for steady income growth, there is an incentive, especially for pension funds, to overcome this inertia. International investors are seen as a potential source of funds because of their greater experience in the sector. The availability of data is a chicken-and-egg problem that has yet to be effectively addressed.

16. Most importantly, investors in the main are looking for a guaranteed income stream, at least while experience is being built up. The UK Government's private rental guarantee applies only to debt so helps to reduce costs and risks but does not directly address the issue of the need for secure income growth.

17. One of the most important issues for investors is the cost and risks associated with management – which determines the gap between gross and net yields. The very limited evidence for Scotland suggests that management costs are relatively high. As important is the lack of a professional management platform specifically concentrated on privately rented housing. Again, there are good international examples but very limited experience in the UK. Housing associations have the most relevant experience, but it is still for a different clientele and housing stock. Some already have for-profit management subsidiaries.

18. More general risks, such as those to do with reputation and regulatory and policy change, are not directly measurable and can best be reduced by experience of stability and success.

## Ways forward

19. Over the last decades there has only been one obviously successful model of new build in the private rented sector where institutions have been involved: student housing. This worked because initially it was de-risked by universities and housing associations and provided guaranteed long-term income growth for institutions. It is now a successful market-based product.

20. Several financial models currently being developed provide routes to financing rental housing. Four approaches where there were functional models in place were identified: leasing models; direct purchase models; aggregated bond financing models; and those that harness the borrowing powers of local authorities and housing associations.

21. Most of these involve some form of subsidy or guarantee, at least initially. They are therefore most suited as means of expanding the provision of social or intermediate rental products, where there is a growing need for additional sub-market but low-subsidy provision.

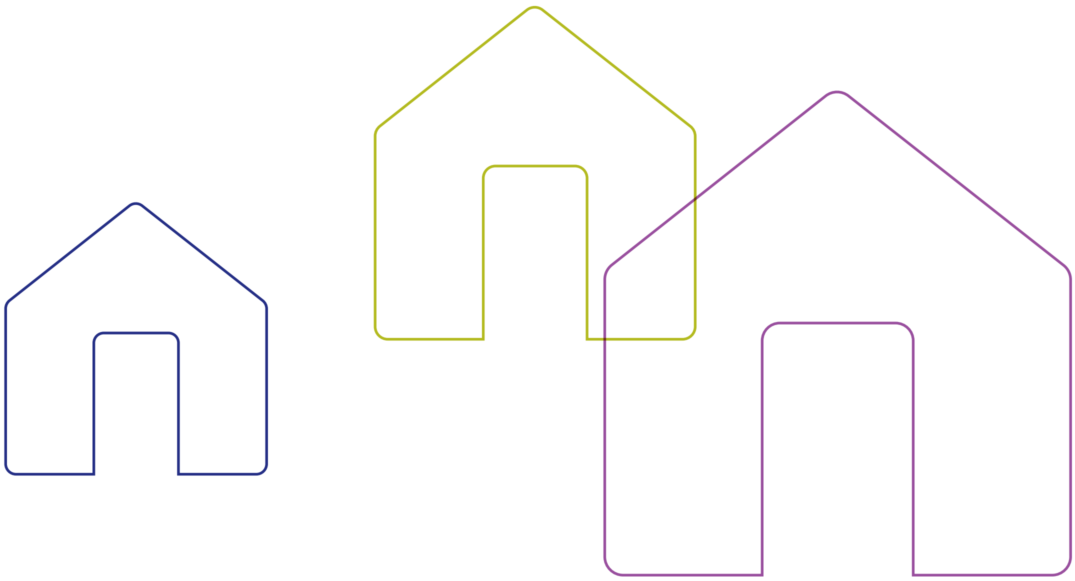
22. The UK Government is also playing a role through the use of the Build to Rent Fund in England and the UK-wide private rented sector debt guarantee scheme. These aim to reduce the costs and risks of finance at different stages of development and ownership.

23. The evidence on successful models is still very limited, in part because the market's interest in rented residential property is a recent phenomenon. What evidence there is suggests that there is a wide range of potentially successful models – from developers maintaining ownership and management through to investors becoming involved at the land-assembly and construction stages. Housing associations are often involved in these models, as initial investors who sell to financial institutions and/or as long-term managers of the stock. There is no dominant financial model emerging, rather a dozen flowers are potentially blooming.

## Conclusions and recommendations

24. All stakeholders must be committed if the emerging opportunities are to be realised. These stakeholders include builders and developers, financial institutions, property management and service providers, housing associations, trade bodies, local government and the Scottish Government. All are taking an active interest, but most, even now, do not see developing a new model of renting in Scotland as a top priority. This has to change if the opportunities now becoming available are to be realised.

25. This report's 20 recommendations set out measures to overcome barriers to the development of a healthy, profitable sector. They call for a great deal of co-ordination and co-operation – and for improved information about and understanding of what is a fast-moving market. At the start of the project the immediate issue was seen to be how to attract institutional finance. Now many investors are showing interest. But it is not yet clear that the price is right – either for investors or for developers. There are big gaps to fill with respect to the availability of high quality management, the transfer process from developer to long-term owner and achieving appropriate scale. All these issues need to be addressed at the same time.



# 1 Introduction

## 1.1 Terms of reference and methods

The main objective of this study is to provide a better understanding of how institutional and other investors can be encouraged to invest in the provision of new rental housing at scale in Scotland and the economic reasoning behind these decisions. We therefore ask both how new build rental homes can be brought forward, and how the longer term financing of ownership and management of rented housing can be secured. The project concentrates on both investment in market rent housing operated by purely private landlords and in either market or sub-market rental operated by registered social landlords (RSLs). It does not deal with construction of traditional social rented housing as this area is already well covered in the literature (Murja 2012).

The research was commissioned by Homes for Scotland and sponsored by the Scottish Government and Construction Scotland. Homes for Scotland's brief (Annex A) sets out several detailed research questions. We were asked to explore the nature of the rental investment product; policy models; and the specifics of investors and their approach to investment.

The methodology involved a literature review followed by interviews with nearly 60 stakeholders, mainly in Scotland and London and valuable discussions with the Advisory Group (led by Homes for Scotland to oversee the project). This allowed us to clarify the policy environment, the barriers to investment, the models used by different stakeholders and the range of possible instruments to support investment. In turn, this analysis has led to a set of recommendations to different stakeholders which, if followed through, could help encourage sustained increases in investment in rental property.

We are very grateful to those we interviewed for their helpfulness and candour. Annex B provides a breakdown of the number of interviewees by professional category. Because some of our conversations touched on commercially sensitive matters we have not identified interviewees by name or organisation.

## 1.2 The problem

Since the beginning of the century the proportion of dwellings and households in private renting in Scotland has increased by a factor of nearly two. However, this increase has come about mainly as a result of transfers of dwellings from social housing, and has been funded mainly by individuals. There has been almost no new construction specifically dedicated for the rental market, apart from in the social sector, and virtually no investment in the rented sector by financial institutions. These are the main issues this report addresses.

Throughout this report, by 'institutions' we mean major financial organisations that pool large sums of money and invest them in assets. Of most interest are annuity funds, a segment of the pensions-fund industry, as they are particularly interested in long-term low-risk investments.

## 1.3 The audience

This report is directed at all those who have a financial or policy interest in the provision of new rented housing in Scotland. The intended audience spans a range of professions and backgrounds, from politicians to local authority housing officers to pension fund analysts. Some readers may find that parts of the report set out material that is (to them) perfectly obvious, or feel that it unduly simplifies matters with which they are familiar. Our goal however is to provide, in a few pages, enough information to enable readers from all starting points to understand the issues from the position of other stakeholders. This has inevitably entailed some simplification but not, we hope, serious distortions.

In this report the terms 'market rented' and 'private rented' are used interchangeably to describe that tenure where rents are determined on the open market. In the main these properties are privately owned, but it is increasingly common for registered social landlords to own and manage private rented housing through profit-making subsidiaries.

(See the glossary for more detail on definitions.)

## 1.4 The starting point: what determines investment in rented residential property?

Investment in the private rented sector at scale has not occurred in the UK since the 1930s, except latterly in the context of student accommodation and elderly care, where successful new investment markets have been created. Investment in the rental sector overall (i.e., including social rent) has been based mainly on the availability of public subsidy to support provision for low to middle-income households by social landlords with a mission to supply to this group. Since the 1970s, private funding for rented housing was available mainly in the form of debt finance, either through buy-to-let mortgages for purchase of existing dwellings or retail and bond finance for development of social and affordable housing. There is thus very little recent experience on which major investors can assess the potential for large-scale investment in rented housing outside the social sector, and no easily accessible indices with which to track the performance of such investments.

The traditional economic analysis of how investors make decisions holds that rational individuals assess the net value of a proposed investment against that of other potential investments. In the context of residential investment, the net value is based on yield – defined most simply as rent divided by capital value. However this apparently simple decision rule hides the complexities behind the definition of 'rent', and the risks and uncertainties associated with the investment as compared to other opportunities. Thus, when an interviewee suggests, as some do, that investors require a yield from private rented investment of perhaps 5 - 7 %, this statement contains within it not only the basics of the calculation (the expected income stream, the costs associated with buying and letting the properties and the relevant interest rate for the specific investor group) but also the expected variance around these estimates and the value placed on uncertainties – such as reputational risk – which can only be guessed at. Professionals often use the term 'all-risk yield' to reflect this complexity. The yield requirement also reflects the interviewee's estimate of the return available on alternative investments.

The fact that the required yield from rented property, as understood by the academic and professional literature and interviewees, appears to have been falling over the last few years suggests that the fundamentals have improved (costs have fallen, income streams increased etc.); that perceived risks have declined; and/or that yields in other potential investment sectors have fallen.

Understanding what determines the required yield, why it may have fallen over the last few years and how it might fall further is at the core of this report. To address these questions we need to understand what has happened or could happen to:

i) Income streams from rented residential property (who the tenants are, what capacity they have to pay rent now and in future, and what their other housing options are);

ii) Development costs;

iii) Transactions costs;

iv) Management costs; and

v) Returns on alternative investments (the benchmark interest rate depends on how the investment is financed and who is investing – alternative investments available to buy-to-let investors are very different from those considered by institutions.

Linked to each of these elements are risks and uncertainties (risks are where investors have a reasonable understanding of the possible variances and can calculate expected values; uncertainties are where at the limit they are guessing). Finally there is a whole range of reasons why actual investors (and those selling to them) do not behave exactly like the models predict they should– e.g., because of the valuation rules they are expected to use or because there are wider issues that decision-makers must take into account. In some of our discussions these are seen as the key barriers to investment.

Underlying these detailed factors are more basic drivers of demand and cost. Demand for rental housing depends not only on what housing is available and the rent to be paid, but also on opportunities in other tenures and even more fundamentally on demographics, incomes and people's longer-term housing aspirations. Costs depend on land, labour market and investment opportunities elsewhere in the economy as well as on the efficiency of development and management in the rented sector. For individual investors and developers these more fundamental drivers are taken as given, but for governments both national and local they are core to the development of sustainable housing policy.

## 1.5 The UK context

Institutional investment in rented housing in the UK went into decline in the 1970s; the strong growth in the private rented sector in the last 15 years has been based on buy-to-let investment by individuals rather than corporate investment. (See Annex B for a brief historical overview.) In the face of growing demand for privately rented housing for a wider range of mainstream households, the UK Government set up the Montague Review (2012) to identify barriers to and opportunities for institutional investment in private renting. It has followed up with a task force to address barriers on the ground, and with subsidies and guarantees to improve returns.

In the past decade the situation has begun to change, and market fundamentals are now stronger than they have been since before 1939. All the elements that affect the yield required for rented housing to compete against other opportunities have seen improvements. There has been rapid growth in the PRS across Britain and demand is high, especially in pressured urban areas (see Halifax, 2013) – so income streams for landlords are stronger and less risky, even though most households ultimately want to own their own homes. There is considerable potential for large-scale developments on regeneration sites, and mixed-community developments are popular especially in London –so there are more investment opportunities. There is a great deal of enthusiasm among stakeholders, including from major investors, especially annuity funds, who see that residential investment could provide a long-term income stream with growth potential that would match their long-term liabilities. There are at least three important missing elements: experience of successful schemes, a pipeline of larger developments suitable for residential rental development and data that would allow decision makers to determine acceptable overall returns and on-going performance. There is also a question as to whether the momentum will be lost as the economy recovers and owner-occupation picks up.

### 1.5.1 Large-scale investments in the private rented sector in England

There are currently very few institutional investments in large-scale rented housing. Most of them are in London. They include Stratford Halo (where Genesis, a housing association, sold part of the development on a 160-year lease to Prudential with an associated management contract and a guaranteed income stream to the investor) and East Village (the private part of the Olympic Village, bought by Qatari Diar Delancey, where a very large number of units will become available simultaneously and there is a clear exit strategy). There are growing numbers of private rented developments led by registered providers (RPs), some of which may be transferred to institutional investors who will receive payments from the rental streams (e.g., Fizzy Living, part of the Thames Valley Housing Association group). The housing associations will continue to provide management services, which helps them to manage exposure /cost of voids for the guaranteed amounts, particularly in areas of high demand.

There are also a small number of examples of 'covenanted' private rental developments in England where the local authority owns the land and requires that the properties be rented for a specified number of years. The first tranche of the UK Government's Build to Rent Fund is in play (in England only), with 45 organisations (both housing associations and private developers) sharing a pot of £700 million. Many more projects are being talked about and are in process.

However, there are continuing concerns about risks and returns and particularly about whether there is a pipeline of sites in suitable areas across the UK. Investor appetite is partly driven by ready supply and a significant market (for both entry and exit purposes) – at present neither condition is fully met but many institutions now expect to have rented housing as part of their investment portfolio over the medium to long term.

This brief examination of the increasing interest in longer term investment in rental housing in the UK (but mainly in England) points to some areas to be explored in the Scottish context:

- First, is there a need for additional investment in the rented sector in Scotland?
- Second, what is the potential for institutional investment in large-scale developments in high-demand areas?
- Third, do housing associations or local authorities have a potential role in developing and/or managing homes in the wider rental market?
- Fourth, can the use of public land and contractual arrangements or covenants on developers or investors help ensure both viability and that the housing remains in private rental?
- Fifth, are there enough available and suitable sites available for rented housing?

## 1.6 The Scottish context

Table 1 provides an overview of the basic statistics on households, the housing stock and new investment for Scotland. It shows that the number of households has grown annually by an average of 18,000 over the period 2001 to 2011, and that while housing completions were keeping pace with household growth in 2001, by 2011 they were running well below that level. It also shows that while traditionally Scotland has had a strong commitment to social rental, the tenure has been in decline over the decade, partly due to the Right to Buy policy, while private renting has grown particularly rapidly.

***See Table 1:*** *Statistics about the Scottish housing market below.*

Table 2 provides more detail on how the ownership of housing stock changed over the decade 2001 to 2011. It shows that the private rented stock grew by 135,000 units, only 7,000 units less than the numerical growth in owner-occupation (143,000). On the other hand, the stock of social housing-especially that owned by local authorities-fell rapidly, particularly in the early years. Over the same period owner occupation grew (to 65% in 2007) and then fell in proportional terms - though not in absolute numbers. The rate of growth in private renting increased after the financial crisis.

What is also important is that during this period, new completions of social and affordable housing were maintained (Scottish Government Communities ASD Housing Statistics). In the six years between 2007 and 2013, some 30,000 units were completed for social renting but the outflow to other tenures more than offset this investment. Equally some 9,000 units were added to affordable home ownership, meaning that mainstream owner-occupation actually declined in the period after 2007.

***See Table 2:*** *Scottish dwelling stock by tenure: 2001 to 2011 below.*

### Table 1

| Item | 2001 | 2011 | Comments |
|---|---|---|---|
| Households | 2.20m | 2.38m | Projected to rise to 2.59 million and to 2.89 million by 2035 (an average of over 20,000 per annum) |
| Housing stock total | 2.31m | 2.50m | Construction kept up with growth in household numbers |
| Owner-occupation | 63% | 64% | Growth in number of owner-occupiers but not now in proportion – see table 2 |
| Private renting | 7% | 12% | Increase of 130,000 units over decade |
| Social renting | 30% | 24% | Decline of 96,000 units over the decade |
| Housing completions | 22,400 | 15,190 | Peak in completions 25,740 in 2007; number still falling in 2012 |
| Private | 81% | 65% | |
| Social | 19% | 35% | |
| Proportion of completions in Edinburgh, Glasgow and Aberdeen | 29% | 20% | The number of households in the three cities is 29% of total households |
| of which private | 69% | 50% | In 2011 % private ranged from 85% in Aberdeen to only 34% in Glasgow |
| Average house price | £76,000 | £171,000 | |
| ONS price index | 100 | 225 | Shows consistent increases over decade |
| Nationwide index | 100 | 211 | Shows fall in 2009 and still not back to 2009 levels |

Sources: National Records for Scotland; Scottish Government Housing Trends; ONS; Scottish Government Communities Analytic Services, Nationwide BS

### Table 2

| Year | Owner-occupation | Private renting | Social landlords | Of which owned by | | | |
|---|---|---|---|---|---|---|---|
| | | | | Housing associations | Local authorities | Total | Increase per annum |
| 2001 | 1452 (63%) | 170 (7%) | 692 (30%) | 139 (6%) | 553 (24%) | 2314 | |
| 2007 | 1590 (65%) | 233 (10%) | 607 (25%) | 261 (11%) | 346 (14%) | 2430 | 01-07: 9,300 |
| 2011 | 1595 (64%) | 305 (12%) | 595 (24%) | 275 (11%) | 320 (13%) | 2495 | 07-11: 6,250 |
| Change 2001-1 | +143 (+10%) | +135 (+80%) | -97 (-14%) | +136 (98%) | -233 (-42%) | +181 (+8%) | 01-11: 8,100 |

Source: DCLG Live table 107: Scottish Government

These figures suggest that both cyclical and structural factors have worked together to change tenure patterns. The rise in private renting, especially among younger households, starts well before the financial crisis and may go back to the early 1990s. But equally, many households and dwellings currently in the private rented sector would move to owner-occupation if incomes rose and credit become easier. Returning to a 2007 tenure split (which is roughly the EU average) would imply that there would be some 30,000 more owner-occupiers and perhaps 11% of dwellings in private renting.

The Scottish Government has set out a vision for a private rented sector 'that provides good quality homes and high management standards, inspires consumer confidence, and encourages growth through attracting increased investment' (Scottish Government, 2013). As the document notes, 'there has been growth in the number of younger people, including those with families, calling the PRS their home.'

Finally, both population and household numbers are set to grow more rapidly in the next decade than in the last – so there is a need for additional housing in all sectors. However, the market for new build homes in Scotland is showing few signs of recovery, with housing completions continuing to fall and running at below 60% of the peak level of over 25,500 in 2007 (Table 1). This is highly undesirable, particularly as the number of households continues to grow and house prices have more than doubled since 2000. Barriers to expanding overall investment include continuing shortages of mortgage credit as well as a lack of confidence in both the employment and housing markets. Development finance is currently difficult to obtain on reasonable terms and many developers are choosing to be self-financing, which limits activity levels. Yet land and capacity are available, as are a number of large regeneration sites.

To meet the projected growth in households of over 20,000 per annum, and to mop up some of the backlog, suggests that output levels will need to return to those achieved in the mid-2000s. If structural factors mean that owner-occupation only returns to 2007 proportions this would entail a contribution from the rental sector (including social, intermediate and market rented housing) of 7,500 – 8,000 units. This level of investment will be far more easily achieved if a healthy long- term private rented sector can be created.

### 1.7 The current position

The historical evidence suggests that the requirements for healthy growth in investment in new rented housing are:

- strong demand from working tenants, many renting for the long term;
- easy access to suitable development sites in the right locations;
- reasonable certainty about securing planning permission;
- clear contractual arrangements and no rent controls;
- adequate finance; and
- a supportive policy environment.

There are many indications that now is the right time for governments to be considering institutional investment in rented housing again. Both the UK and Scottish governments have increasingly recognised that market and intermediate renting are important parts of overall housing provision. They recognise their role in catering both for market demand and for households on benefits (although institutional investors are less likely to focus on this part of the market). As importantly, both governments have recognised that all parts of the housing market need to contribute to overall provision, such that there is choice and availability.

## 2 Barriers to investment in rented housing

The question of how to attract institutional investment into the rented sector in general, and private renting in particular, is one that has attracted the attention of academic experts and policy-makers for several years. Some other countries —particularly Germany and the USA — are perceived to have better-operating sectors, which is ascribed in part to the role that institutional investors play in those markets (although in fact in both countries, as in the UK, small 'amateur' landlords own most rented property [Scanlon and Kochan 2011]). In the UK, on the other hand, institutions and property companies were important actors up to the 1960s but then withdrew almost entirely, usually by selling properties into owner-occupation (Hamnett and Randolph, 1988).

Table 3 lists the most important barriers to institutional investment in the rented sector, according to our interviews and to recent reports by policy and academic experts (Crook and Kemp, 2011). We have treated them in five categories:

- Those to do with new construction, especially that for the rented sector
- Those to do with institutional investors and their decision-making processes
- Those around the return on private rented property
- Those to do with risk, and
- Scotland-specific issues.

**Table 3: Barriers to the development and ownership of private rental housing**

**a. Land and construction**

| | General issue | Specifics | Important to developers/investors? |
|---|---|---|---|
| 1 | Value of land driven by owner-occupation | Developers who want to build for rent cannot outbid those building for owner occupation | Developers |
| 2 | Supply of land | There is not enough developable land in locations that would work for rental housing<br>Planning controls<br>Requirement for public bodies to obtain best value for land sales<br>Local authorities unwilling to lose commercial/industrial land to housing<br>Lack of an adequate pipeline of development land with full planning permission in attractive areas<br>Interest in separate use class for private rented housing but no consensus about whether a good idea | More relevant to developers than investors |
| 3 | Local authority policies | Local authorities' position on S75 contributions, which affects viability<br>General attitude to private renting<br>Private rented housing not sufficiently covered in local housing needs assessments<br>Local authorities steer developers towards particular sites that may not be suitable for private rented housing<br>Lower value of rental developments implies foregoing affordable housing and other infrastructure (e.g. schools) provided through S75<br>Proposal that PRS development be treated as affordable housing | More relevant to developers than investors |
| 4 | Lack of development finance | Banks will not lend to developers, or do so on onerous terms<br>Some developers self-funding, even if they could access bank finance, because of terms<br>Some have long-term arrangements, especially large developers and housing associations | More relevant to developers than investors |

**b. Investor attitudes**

| | General issue | Specifics | Important to developers/investors? |
|---|---|---|---|
| 5 | Investor unwillingness to take planning/development risk | Would enable higher returns but does not fit investment style of many long-term investors | More relevant to developers than investors |
| 6 | Investors' mandates (industry benchmarks) | Pension funds in particular required to track industry indices, and residential property is not included in them | Yes to some |
| 7 | Illiquidity of residential property | Residential property transactions can be long and costly; relevant to exit strategies if these involve sales | Depends on investor |
| 8 | Lack of robust market information | Rent indices and detailed evidence on costs and performance underdeveloped compared to commercial/office property | Possibly important to investors |
| 9 | Management | Investors do not know if they can accurately assess gross-to-net reduction<br>Some investors want arm's-length management platform; others prefer to manage in-house | Yes |
| 10 | Lack of expertise within investment houses | Chicken and egg: no expertise as few investments; few investments as no expertise | Beginning to be recognised |
| 11 | Scale of potential investment | Institutional investors want transactions worth at least £10m and preferably £50m, and current rental developments are too small | Yes |

## c. Yield vs. commercial property and other investments

| General issue | | Specifics | Important to developers/investors? |
|---|---|---|---|
| 12 | Predictability of demand into the longer term | The rise in PRS over the last few years has been large but unclear what proportion is cyclical and what structural | Yes |
| 13 | Location | In appropriate locations units will rent more quickly, attract higher rents and experience fewer voids<br>PRS at market rents only works in higher-pressure areas, and specific locations<br>Regeneration sites may offer opportunities but have higher risks | Views differ |
| 14 | Product features | It may be difficult to let large developments rapidly and maintain low vacancy rates if units become available at the same time | Yes – tend to want to purchase after first letting |
| 15 | Taxation | Efficient management reduces gross-to-net margin by reducing direct costs and turnover<br>Good management reduces reputational risk, e.g. by reducing evictions and dealing with problem tenants effectively<br>Inadequate benchmarking of individual costs | Yes |
| 16 | Product features | Units specifically designed for renting may be cheaper to manage<br>Eventual managers (e.g. RSLs) want role in specifying units<br>Issues around optimum site scale and tenure mix; flats vs. houses | Yes to long-term investors |
| 17 | Taxation | SDLT and VAT on management fees reduce yields compared to commercial property | Yes - affects yields and exit strategy |
| 18 | Price | Mechanisms for including future rent increases in valuation not well developed; rules as they are employed are often not comparable to share valuation re capital gains<br>What is appropriate discount for bulk sale to investor? | Yes |
| 19 | Reputational risks | Still seen as important issue at investor board level – both with respect to own investment and the reputation of the sector<br>Local experience associates PRS with criminality/ASB | Yes |
| 20 | Regulatory and policy risks | Potential investors wary of imposition of rent controls, security of tenure and/or longer leases in Scotland<br>Concerns about the relative position of private renting to other government initiatives and the possibility of crowding out | Yes |

## d. Scotland-specific issuess

| General issue | | Specifics | Important to developers/investors? |
|---|---|---|---|
| 21 | Specific knowledge of the Scottish environment | Those not already involved in Scotland have little understanding of opportunities | Yes |
| 22 | Independence vote | Uncertainty means investment decisions deferred at least until after vote | To some but not all |
| 23 | 20-year lease and standard security rules | Housing (Scotland ) Act 2010 exempts social landlords and rural housing bodies from the lease rules and allows them to opt out of the standard security restrictions; the 2011 Housing Act allows for other bodies to be designated as exempt | Some investors unclear of implications |
| 24 | Regulatory and policy risks | Uncertainties about possible imposition of rent control, security of tenure and/or longer leases | Yes as part of general concern about the sector |

### 2.1 Barriers to new construction

The first part of Table 3 deals with barriers to new construction. The main thrust of both the interviews and the literature is that there simply is not enough new supply of rental housing or new housing in general. The reasons include lack of adequate land supply in the right areas, the application of planning controls, and differences of views between developers and local authorities as to the economics of private renting and its locational requirements.

In terms of land supply, the problem is not seen to be an absolute shortage of building land, but rather a lack of land in the high-demand areas that could sustain rental developments. Even where land is available it is often difficult for rental developers to acquire it, since they must bid for land against those who are building for owner-occupation. In many circumstances owner-occupation, and indeed buy-to-let, will generate a higher capital value for the properties (e.g. because the prices include expectations of future capital gains) and therefore a higher land value. (See Annex D for a discussion of the calculation of development land value.) Circumstances where this might not be the case include large sites where the build-out rate can be much higher for rental properties and certain types of flatted accommodation which can be managed more cost effectively as rented housing. Even in these circumstances, developers will normally wish to sell certain parts of a development (e.g., the last phase or penthouses) into owner-occupation. In lower demand areas where capital gains are not expected but rents may increase with incomes, rental values can be higher than owner-occupied prices -but in these circumstances it is likely that there will be other barriers to development.

Another barrier can be the requirements under S75 of the Town and Country Planning (Scotland) Act 1997, which allows local authorities to seek planning obligations or contributions on developers (e.g. a proportion of affordable units in a new housing development or a contribution to new schools). These are calculated on the basis of the value of the proposed use. Compared to sale into owner-occupation, a (mainly) rental development will normally offer a lower margin for the developer from which to offer S75 contributions.

Local authorities that relax S75 requirements for this reason need to show that they meet defined housing needs – which may be difficult since most local authority Housing Need and Demand Assessments do not break out the demand for private rented housing within the market sector. Even if the local authority agreed to relax S75 requirements on this basis it is likely to want to ensure that units would remain in the rented sector rather than being sold into owner-occupation. Similar issues arise with respect to the valuation of public land at highest and best use.

The decline in the rate of new construction in the wake of the financial crisis stems not only from uncertainties with respect to demand and issues around planning and land supply, but also from developers' problems in accessing finance. Banks have tightened lending criteria significantly and are now much less willing to fund speculative development; this has particularly affected small residential developers but has also had an impact on major firms. Many developers appear to be mainly self-financing which limits their potential level of activity and this has opened the way for investors to move directly into the development market. Moreover, in current conditions, it is easier for developers to build houses than flats, as it reduces the amount of capital they have tied up. This is an issue for the rented sector because large apartment buildings are a more cost-efficient way of providing rented accommodation—and attractive to the types of household that form the core demand for private renting.

Although banks are unwilling to fund speculative development, they will still fund construction if a suitable third party has committed to buy the completed units; this is the mechanism employed, for example, by the National Housing Trust initiative which has operated in Scotland for some years (see Annex E). The inclusion of affordable housing in the development, which generates early payments, can also be helpful.

## 2.2 Investor attitudes

In the UK, institutions and property companies were historically involved in the PRS, but generally disinvested in the second half of the 20th century and now have limited expertise in the sector. The market for investment in commercial property, on the other hand, is mature and institutional investors are active and well-resourced in this market, which they understand well. Commercial property is normally sold to investors once it is completed and let on fully repairing and insuring leases of 10 or 15 years with a 10-year break. The leases have regular upward-only rent reviews and the capital value of the asset falls over time, unlike residential. Ideally potential investors want a 'perfect' product with certain rental growth and controlled costs. The challenge therefore is to make residential perform in somewhat of the same way - or change investor perceptions and expectations.

Table 3b sets out the issues that affect institutions' attitudes towards investing in the rented sector. Certain elements of their worldview inform how they see this type of investment. In particular, institutional investors (especially annuity funds) are looking for predictable long-term income streams that will be a good match for their liabilities. Despite some counter-examples, most institutional investors wish to purchase either on completion or after first letting – although they (or their designated managers) may well want a say in the specification of the properties. Their time horizon would be decades, increasing the benefits of a certain income stream - although many investors still want a clear potential exit strategy. This suggests that a new business and financial model needs to emerge alongside 'build to sell' or 'build to own and let at social or affordable rents'.

Within institutions there are information and internal structural issues about how the market operates that may deter investment. Pension funds are often advised by their consultants or actuaries to follow investment strategies designed to track particular market benchmarks. Institutionally funded residential property for private rent, as a nascent market segment, does not appear in any of the widely used property benchmarks, and some interviewees said that until it does there will be little institutional interest - and as a corollary, little institutional expertise. A more general issue lies around detailed evidence of costs, rents and yields. IPD is the only source of such information that is recognised by investors, in part because they have provided that service for retail, office and industrial properties for decades. Their residential index is much younger and has relatively limited coverage and, while nationwide, is heavily concentrated in London. Information on Scotland is almost entirely limited to Edinburgh.

Some interviewees disputed the importance of indices, saying that investment managers should try to beat rather than track them, and that they should be willing to place at least a small portion of their money in non-benchmarked assets. There is evidence that a few financial institutions have adopted this attitude, but so far their initiatives appear to depend on a small number of individuals in a position to modify internal rules. Gradually others may 'dip their toes in the water'.

A further issue for institutions is that they generally do not want to manage rented housing themselves, but want 'platform-level investments'—that is, rental businesses that are already up and running. Management needs to be competent so the investor is not associated with bad publicity (reputational risk was seen as a very important issue) and efficient so as to minimise the gross-to-net reduction (the difference between total rent received and net income after costs—see Annex D). Benchmarking is important – and concerning: while the most efficient managers claim management costs account for about 20% of gross income (the gross-to-net reduction), the IPD average gross-to-net reduction is 35% for the UK overall and 47% in Scotland (IPD Communication). Again there is a major problem of expertise, as there are relatively few managers of large-scale housing outside the housing association and local authority landlord sector, and the majority of the residential letting sector is either self-managed or managed by local estate agents.

Not all new build rented properties are equally attractive to large investors. Major investors are looking for transactions worth £10 million minimum, and preferably much more - £50 million seems to be the benchmark. They do not want to assemble these portfolios themselves but will purchase existing portfolios of sizeable residential blocks or, occasionally, of scattered units.

In the past, these barriers have together been seen as insurmountable. This is now changing and there is increasing investor interest in the sector. In Edinburgh, investment in private rental stock is already happening across the city at both small and large scale. A recent deal saw Hearthstone Investments acquire two blocks at the Miller Homes developments at Varcity North and Varcity South, close to the city centre. The units will be let and held as investments. A recent presentation in London by the Resolution Foundation of their model for attracting institutional investment to rented housing attracted a large audience including many senior people from the investment industry. A number of transactions have already taken place as UK and overseas institutions trade, build portfolios of existing units or take part in new schemes. The current environment is undoubtedly the most positive in living memory.

## 2.3 Yields

For all the interest currently being shown, the main barrier to investment remains that rented housing is seen to produce inadequate yields in comparison to commercial property or other alternative investments. Table 3c lists the main factors mentioned by interviewees.

In part this is because of the different ways yields and development or residual valuations are defined. If future rent increases and potential capital gains are not included in that calculation, then the yield threshold depends on how residential property is categorised in terms of risk, and how the broader-based risks discussed in Annex D are evaluated. What is clear from interviews is that acceptable initial yields are falling and are now in a range starting from significantly below 5% when rental returns are guaranteed to as much as 8% (although it is by no means obvious exactly what these numbers include).

Location has been included amongst the factors that affect yield—although it could equally have been listed under investor attitudes. Location should not matter as long as the yield is right – however the yield required will be different in different individual markets, because the perceived risks differ. In practice institutions providing funds for developers 'are likely to be very selective in terms of the property developers that they lend to and the location and nature of the schemes' (Isaac, O'Leary & Daley 2010, p.145). Our discussions also suggested that while some annuity funds are already looking to Scotland, there are major investors who are more comfortable investing only in London and the southeast than elsewhere in the UK – especially if discussing new build.

The core element affecting perceived risk is demand. Demand has risen rapidly across all parts of the rental sector in Scotland as in the rest of Britain, although growth has been concentrated in the market and, to a lesser extent, intermediate sectors. There are both cyclical and structural reasons for these changes and it is currently difficult to be certain about the equilibrium number and make-up of households who will live in the market sector. This uncertainty is currently reflected in falling rents in some parts of Britain even though they are clearly continuing to rise in more pressured areas. UK and Scottish Government policies that support owner-occupation, notably Help to Buy, may also reduce demand if maintained.

The efficiency of management has a direct effect on costs and thus on yields. Amongst interviewees there were differing views about the optimum scale of holding in management terms; one interviewee said a landlord needed 400+ units in one place, another 150; at the other end of the scale we were told that at least 10 units in one street were sufficient to drive efficiencies.

Several interviewees said that large-scale developments on single sites would have lower management costs than portfolios assembled from units across several sites, and that therefore these should be preferred.

Costs are affected by the physical characteristics of the rented dwellings. There was a range of views about whether rented housing should ideally differ physically from owner-occupied housing, and if so how. Many of the existing financial models for rented-sector investment are based on an exit strategy of selling the units into owner-occupation after a time, in which case radically different physical products are probably not an option—although it was seen as important to have something robust that would still have kerb appeal after 10 years in the rental market.

The main elements that might be different in rental-specific housing related to (a) provision for households consisting of adult sharers and (b) minimising repair and maintenance costs for the landlord. They included:

- Equal bedroom sizes, rather than one master bedroom and one or two smaller ones
- En-suites to all bedrooms
- nstallation of goods lifts in blocks of flats, so passenger lifts or staircases did not get damaged by the movement in and out of furniture and belongings
- Better-quality kitchens for durability
- Fitness clubs or other communal facilities
- Standardisation of e.g. boilers so a single maintenance team could service them all; good access to heating and plumbing
- Wide corridors and doors

The property managers we spoke to – most of them housing associations - said that if they were to manage private rented housing they would want to be involved from the outset so they could influence design and specification. This of course would be subject to construction procurement rules.

Costs are also affected by turnover. The six-month to one-year Short Assured Tenancy which dominates the private rented sector in Scotland does not mean that people actually move on at the end of the initial contract. The evidence is that average length of stay has been increasing and is now between two and three years. However, longer leases for unfurnished property may be one way of reducing turnover and enabling people better to see their rented unit as home (again reducing costs).

Taxation also affects costs and yield. The Land and Buildings Transaction Tax (2013) provides enabling legislation, but there are concerns that the transactions costs for the sale of large numbers of units will be high, even though a bulk purchase rate is envisaged. It can also be attractive for investors to buy the land rather than the completed development as they then only pay stamp duty on the former. Another tax issue is VAT on management fees; this cannot be recovered on residential (unlike commercial).

Apart from rents and costs, the other determinant of yield is initial price. Many of the potential investors we interviewed said that residential property was too expensive in the UK overall, and in London but also in Edinburgh in particular. Therefore yields are seen as too low and risks of capital losses too high.

Capital values are normally provided by valuers using evidence from capital transactions. Valuers normally value residential property assets on the basis of owner-occupation and single sales because that is what lenders instruct. The resulting asset values result in low yields. An alternative, often used by housing associations, is to value properties on the basis of discounted cash flow as for commercial property—this emphasises rental streams and is the approach that many investors understand (see Hill 2006). A Royal Institution of Chartered Surveyors working group in England has been looking at the principles of valuing covenanted private renting because of the lack of experience in living memory of valuing long-term rented residential assets. One suggestion is that rents should be uplifted by CPI – however the most likely impact of such a change on decisions would be to modify the comparator that takes account of perceived increases in risk.

Interviewees involved in developing rental property felt that annuity funds should view investment in rented housing as a long-term commitment that would produce a utility-type income stream, and look for net yields of around 4% net. There was little evidence however that pension fund managers shared this view; required income-only yields seemed to be from 4.75% and (a long way) up.

In principle, a developer might be prepared to sell portfolios of rental units for less than identical owner-occupation units because they would not have to pay the cost of marketing, would benefit from efficiencies on build costs, and could accept a lower profit margin if the development was pre-sold. Amongst our interviewees, developers seemed to think a discount of 5% for these reasons was about right, while non-developers saw 10-15% as desirable.

There are a range of issues where it is not possible to quantify the impact on yield or the choice of comparator. There are important areas of perception and attitudes that can carry more weight than formal yield calculations. These include fears that the organisation's and sector's reputation may be damaged; difficulties in achieving first and subsequent lets that are consistent with expectations with respect to turnover and quality of tenants; and policy risks which centre mainly on fears that there will be sudden changes in regulatory regimes.

## 2.4 Scotland-specific issues

Table 3d sets out a number of issues specific to Scotland. The core question relates to yields: where in Scotland would rented housing produce the kinds of yield that investors require? The general view expressed by both developers and investors was that it would work easily only in a few areas, including Edinburgh, some parts of Glasgow, Aberdeen, Inverness and maybe St Andrews. This is more because demand has been observed to grow in these areas than because there has been detailed analyses. On the other hand, other interviewees suggested that particularly in Edinburgh, rental yields and capital values were wildly out of alignment, and that rents would have to rise or values fall to bring yields to a level where the return would be acceptable to an institution.

Most interviewees outside Scotland had not thought of Scotland as a place in which to invest any more than most had thought of looking far outside London for new market rental provision. The position was different for those already investing in Scotland and especially those for whom Scotland was the main focus of their activity.

There was a strong view among some of the interviewees – both in England and Scotland, and across all professional groups—that investors would defer decisions until the independence question was settled. Institutions that had no office in Scotland and no existing exposure to the rented sector were unlikely to commit in the face of an uncertain political situation. Others however said it would make no difference. In any case it was recognised that this was a short-term question that would be determined one way or another within less than a year.

The final detailed issue identified were the so-called 20-Year Lease and Standard Security Rules . The changes brought in under the 2010 and 2011 Housing Acts, which created exemptions for social landlords and rural housing bodies, plus opportunities for similar exemption for private-sector bodies through a different route. However some investors saw this as a continuing problem.

More general issues related to perceived uncertainties around taxation and regulation. These are dealt with in section 3 below.

See http://www.scotland.gov.uk/Publications/2010/03/04140613/8

## 3 Ways forward: overcoming barriers to development and investment

Table 4 sets out the most important suggestions made in the research literature and interviews on how to address the range of identified barriers found in the literature and in interviews into three groups: those to do with development; those affecting institutional attitudes to investing in private renting; and those affecting yields and the risks affecting the required yield. There are also some Scotland-specific issues.

### 3.1 Solutions to development and funding barriers

Overcoming development barriers requires financially viable projects which can compete for land against owner-occupation and sometimes commercial projects; buildings and units that meet the needs of owners, managers and tenants; and reasonable financial opportunities. Here we concentrate on three core suggestions: tying development into private renting for long periods; public/private partnership approaches to the use of public land; generating scale; and forward funding.

#### 3.1.1 Requiring new housing to be rented for long periods

With respect to tying sites into private renting, the apparently most straightforward approach favoured by some commentators is a new use class for private renting. There are obvious difficulties with such an approach where it is introduced simply to cut land values. It would be likely to result in land being withheld in the hope of change; it goes against the fundamentals of tenure neutrality embedded in the planning system; it is inflexible in the face of changing circumstances and the need for mixed-tenure development; and it cuts off potential exit strategies for developers and owners, thus increasing risk. This is particularly the case if there are problems with the early period of initial lettings - since initial investors may need flexibility to exit through sale if needed. Countries with this style of approach (such as Denmark, Sweden and the USA) have seen private rented new development dry up and developed new ways (such as condominiums) for enabling transfer as circumstances change. The result in all cases has been a smaller private rented sector.

A system which goes more readily with the grain of current UK (although perhaps not with Scottish) legislation is where a separate contract requires that all or (more likely) a proportion of the units in a development be let for a number of years. One way forward, currently being trialled in England, is what is being called ‘covenanted private renting’. Here the public sector land owner, when leasing their land to a developer or other organisation, imposes a requirement that the units be kept in the rented sector for a period of time (perhaps 30 years, although usually with some potential for review if circumstances change). One impact is to reduce the value of the land and so satisfy the district valuer’s requirement that highest and best use is being achieved. The other is to enable rental-specific developments which can have lower running costs and a larger demand. It can act as a substitute for planning obligations which currently only enable affordable housing. There have as yet only been a few examples, all on publicly owned land in London and the South East. They include the Olympic Park, Kensington and Chelsea, and North Hampshire. In all three cases they depend upon the public ownership of the land and thus the power to contract/impose such restrictions. In many ways this is an alternative to S75, and can be used where the land owner is prepared to take the hit on price directly to achieve the aim of meeting housing need.

In the context of using planning gain to support rental housing, a few interviewees suggested that planners could treat new rental developments as if they were affordable housing, which would obviate the need for S75 for affordable housing entirely. The current planning guidance is ambiguous about whether this might be permissible in some cases. It says ‘Affordable housing is defined in the Scottish Planning Policy as housing of a reasonable quality that is affordable to people on modest incomes. In some places the market provides some or all of the affordable housing needed….’ (Scottish Government 2010 p. 2) However the examples given of affordable private rented housing do not include market housing; the guidance lists ‘Mid-market or intermediate rented: Private rented accommodation available at rents below market rent levels in the area and which may be provided either over the medium or long term’ (ibid). This suggests that treating new rental developments as affordable housing would probably not be possible, at least in those areas where such developments would be most obviously economically viable.

Another approach would be to use a modified S75 to achieve similar aims. However, the Scottish Government view was that using S75 to require market-rent accommodation would be extremely hard to justify (see discussion on page 14).

### Table 4: Overcoming barriers to development

| | General issue | Possible ways to address | Who can do it? |
|---|---|---|---|
| **About development and finance** | | | |
| 1 | Value of land driven by owner-occupation | Create a new use class for private renting | Government |
| 2 | Supply of land / planning controls | LAs identify and/or designate land specifically for rented housing<br>Make use of flexibilities in planning system: reducing requirement for S75 contributions for rented housing<br>Use S75 to impose covenants on rented stock<br>Allocation of public sector land<br>Public bodies accept deferred payment on land, joint ventures<br>Government to experiment with a wider definition of 'value for money' in public land sales | Government |
| 3 | Information gaps within local authorities | Include private rented housing in local housing strategies | Government |
| 4 | Lack of development finance | Build to Rent fund | Government |
| 5 | Existence of opportunities at suitable scale | Build to Rent fund<br>Aggregate units on various sites | Government, private sector |

| | | | |
|---|---|---|---|
| **About investor attitudes** | | | |
| 6 | Investor unwillingness to take planning/ development risk | Evidence of successful involvement of all parties from early stages | Individual institutional investors and developers |
| 7 | Investors' mandates (industry benchmarks) | Get residential into the property benchmark | Private sector: involve Scottish Financial Enterprise (SFE) |
| 8 | Illiquidity of residential property | Identify exit strategies more transparently and ensure all-risk yields clearly take into account. | Valuers and institutions including SFE |
| 9 | Lack of robust market information | Produce better information | Support IPD in strengthening residential index. involve SFE |
| 10 | Management | Involve RSLs as managers | Private sector, RSLs |
| 11 | Valuation rules | Change the basis for valuation | Private sector |
| 12 | Lack of expertise within investment houses | Creation of expert task force | Government |

| | | | |
|---|---|---|---|
| **About yield** | | | |
| 13 | Management | Involve RSLs, and potentially other social landlords, as managers | Private sector, RSLs, local authorities |
| 14 | Product features | Early involvement by managers to minimise long-term costs | Developers, institutions and managers |
| 15 | Location | Make large-scale sites in accessible locations available for residential development | Local authorities |
| 16 | Taxation | Change rules re VAT/transaction taxes | Government |

| | | | |
|---|---|---|---|
| **Other barriers** | | | |
| 17 | Management | Higher quality management | All stakeholders |
| 18 | Regulatory and policy risk | Clear and certain policy direction | Government |
| 19 | Income and nature of demand | Guarantee rental income<br>Longer-term leases | Government, RSLs, private sector |
| 20 | Letting risk | Guarantee rental income | Government, private sector, RSLs |

### 3.1.2 Partnership approaches to use of public land

Given current relative returns and funding constraints, making private renting stack up often requires a land owner, such as a local authority, NHS trust, etc., who is prepared to take an equity stake and/or is willing to defer receipt of payment until after the development is complete. An equity stake, which could include deferred payment for land, is another way of addressing the requirement that local authority assets be sold into the 'highest and best use', and could in principle be combined with a covenant and/or S75 approaches discussed above.

Even so, a public owner would only allow land to be used for new private rented housing if it accepted that private renting as a necessary and desirable element in local housing provision. Also, because large-scale investment in private renting is still in its infancy (at least post-WWII), developers and institutions are looking for simple sites in the types of accessible location where demand is likely to be high. This may mean taking from commercial opportunities as much as from residential – and will usually require that sites are 'shovel ready' in order to reduce development risk. All of these requirements imply that both the public landowner and the local authority must have a strong commitment to new rented housing which may best be reflected in clear identification in local needs assessments.

### 3.1.3 Scale of developments

Sufficient scale is seen as important for both developers and institutions if this new style private rental is to be made available. Equally, large sites are seen as the best way to meet housing requirements. The biggest benefit to the developer is that the rate of build-out in a development with a substantial proportion of rented housing can be much more rapid than developments that go entirely into owner-occupation (where there are rules of thumb about the number of units that can be sold and mortgaged each year). Especially in the current financial environment, where developers have difficulty raising debt finance without a large proportion of pre-sales, developers are seeing private renting as a desirable option especially for the early phases of large projects. For smaller projects, sales to international investors (who often place the units into the rented sector) and buy-to-let sales can play a similar role.

One way forward is to have one or more aggregators that act as intermediaries to pull several projects by smaller construction firms together into the scale required by institutions. Some interviewees argued that although aggregation implies higher costs (because the units would be dispersed across several sites), there would be offsetting benefits in terms of an increased range of locations and diversification. THFC aggregates demand for debt finance for social and affordable housing, while other models (e.g. Bellerophon) aggregate demand for dwellings. Homes for Scotland have shown themselves to be well placed to play a role in identifying and bringing builders with an interest in selling into private renting together with potential funders. This is a role that could be extended, especially if some form of Build to Rent Fund were available to support the development phase.

### 3.1.4 Forward funding

Institutional investors will forward-fund some prime commercial projects, handling both short-term development funding and longer-term finance or purchase of the completed property. Although most investors and developers interviewed were clear that investors are mainly interested in purchasing completed and let schemes—as indeed is commonly the case in commercial property – there were examples of investors prepared to use this model in the private rented sector. Indeed, at least one financial institution planned to become directly involved in the development process and foresaw spending large amounts to purchase land and employ building contractors, once they were convinced that yields were sufficient. However these examples all ultimately required a secure fixed income stream. There were also indications that some developers were prepared to take on longer-term ownership responsibilities, perhaps looking for institutional funding once the development is mature.

### 3.2 Solutions to barriers around investor attitudes

The issues around investor attitudes have already been rehearsed. They cannot readily be overcome without adequate data and benchmarking capacity. Fundamentally it is a chicken-and-egg problem: once there are a few examples of investments that work, other investors will reduce their risk assessment and money can follow development. There are a few 'early adopter' investors active in the market now; when they can demonstrate success others will join them.

#### 3.2.1 Concentrate on non-UK investors

In this context, there may be benefits from concentrating on non-UK investors. Several interviewees pointed out that non-UK organisations have taken a leading role in rented-sector investment to date in other countries. Rental housing is a well-established investment category in countries like the USA (c.f. the involvement of the Washington State Pension Fund in new build for rent in London). Sovereign wealth funds operate with very long time horizons, and may have less shareholder pressure to produce immediate returns (c.f. Qatari Diar's investment in London's East Village). They may well provide an example that UK investors will follow.

#### 3.2.2 Employ social landlords as managers

Several interviewees suggested that housing associations could expand their role into the private sector by taking on letting and management, which neither most investors nor most developers wish to be involved in. This could help bridge the gap from development to production of an income generating residential asset whose ownership could be transferred. Investors may prefer housing associations to assume all void and management risks, which has been the case in the few examples identified in England. The Scottish Housing Regulator would need to take a view about the extent to which this would be permissible in the Scottish context.

Involving housing associations is seen as one important way of introducing professional management expertise. The need for quality management is generally regarded as both one of the barriers to building a professional private rented sector at scale, and one of the largest gaps in capacity. Housing associations and local authorities have expertise in managing rental housing. They differ in size and the degree to which they are already involved in commercial management, but the best are in a strong competitive position to provide services to investors. Many RSLs are not thought to be interested in becoming involved in this way, but some (particularly the larger associations) saw it as a definite business opportunity.

Many of the investors we interviewed emphasised that private rented stock required a different management approach from social stock, and that social landlords would not be able to use the same techniques for both.

Other sources of quality management include major property consultants and agents who have long experience in commercial property management. Some developers are also prepared to play this role where they maintain an interest in the properties after completion. A number of well-known names in the field are looking to learn lessons from the USA, both about high-end properties where they see the benefits of providing additional services (e.g., restaurants, spas, gyms, concierges, etc.) and accommodation for middle-income families.

One issue raised in this context is the type of lease that should be on offer. Most interviewees wanted no change in the legal lease framework (Short Assured Tenancies (SAT) in Scotland, Assured Shorthold Tenancies (AST) in England), but were prepared to look at longer leases - and lenders are also now looking closely at this. Some evidence from London suggests that tenants are less interested in longer leases than in knowing that they can renew the lease when it expires.

### 3.3 Solutions to barriers around yield

The most common proposed solution to the perceived inadequacy of return from rented housing is that rents should be guaranteed in some way. This would provide certainty about the income stream, and the reduction in risk would enable investors to accept a lower yield (see discussion in Annex D). Existing examples mainly involve housing associations guaranteeing income or, at the least, a flow of appropriate tenants to maintain low vacancy rates in very specific circumstances such as care homes using the lease model. This is possible because rents in such developments are below market levels, which allows rents to rise and tenant types to change in the face of unexpected variations in demand or cost.

Many investors are looking for government guarantees in this area, but so far government has only guaranteed long-term debt finance, not rental incomes. There are good reasons for this, not least is the difficulty in separating rental income from the effectiveness of the management function and leakage of risk from the private to the public sector. Currently a number of institutions are preparing to put their toes in the water – and not surprisingly trying to obtain all the help they can get from government. Government must decide which initiatives are worthy of support, and ensure that government benefits from uplift.

### 3.4 Solutions to barriers related to government policy

An issue raised by interviewees from several professional groups was the role of government itself, particularly in tax, regulation and policy.

#### 3.4.1 Land and Buildings Transactions Tax

The Land and Buildings Transactions Tax (Scotland) Act 2013 makes provision for a new tax to replace Stamp Duty Land Tax from April 2015 and introduces a more progressive tax structure. The 2011 UK Budget included changes to SDLT which meant that large-scale investors typically pay 1% instead of 5% on bulk purchases, with the tax now assessed on the average value of individual dwellings rather than on the overall value of the portfolio. This was seen as a major breakthrough in holding down transactions costs and increasing the incentive to invest at scale. Interviewees saw it as extremely important both that this would remain in place and that transaction-tax levels in Scotland should not rise significantly, as this would put Scotland at a disadvantage as compared to other parts of the United Kingdom. The first is clearly envisaged; the second is yet to be determined.

#### 3.4.2 VAT, capital gains tax and REITS

Other areas where taxation policy can impact on incentives to invest in private renting lie with VAT, Capital Gains tax and REITs as transparent tax-efficient instruments. REITs in particular are a potentially powerful mechanism for channelling investment into residential property, but they only come into play once mature portfolios can be assembled. They are less relevant to this report, which is about how the new housing that would go into such portfolios can be funded, but might become an important tool once a stock of investable housing has been created either from buy-to-let portfolios or from other owners. Currently responsibility for all of these lies with the UK Government. Were powers to be transferred to the Scottish Government it would be essential to keep the overall package of property taxation under review.

A final area of concern remains regulatory and policy change. All interviewees stressed the need for stability and clarity in both regulation and policy. In particular, no developer or institution wished to find themselves in a situation where they are taking downside risk without the possibility of upside gains. Memories are long and stakeholders can easily be frightened away, even by policy changes which apparently would have no direct impact on returns.

Of particular importance is that any changes to rent determination or security of tenure should not disadvantage Scotland as compared to the rest of the United Kingdom. In this context, while some investors looking for index-linked income would be prepared to offer longer security than is currently available under SATs, and indeed to cap rent rises to a particular index, this was seen as an issue to be addressed in specific contracts not by changes in the regulatory framework. More generally, almost all stakeholders would prefer to maintain the current framework and to ensure predictability with respect to regulation and policy. In particular, they are concerned that the private rented sector should not appear more regulated than that in England as this could undermine investor interest.

With respect to policy, the current government emphasis (both in the UK and Scottish governments) on supporting households into owner-occupation is important here. If effective, it will reduce demand for private renting from mainstream households – and probably benefit public finances in the longer term. If such initiatives offset cyclical decline but leave structural increases in demand for higher quality professionally managed private renting untouched, there is little reason to be concerned about longer-term demand. However, the evidence on the relative importance of cyclical and structural changes is unclear, and it is important that government initiatives do not narrow the gap for effective initiatives to provide privately rented housing.

In Scotland, similar issues surround grant availability for social housing and for mid- market/affordable solutions. These meet demands further down the income scale but still affect the numbers looking for accommodation in the private rented sector overall.

## 4 Ways forward: new approaches to investment and finance

A major focus of this report is how to ensure adequate funding for much larger scale investment in the rental sector than has been achieved in the past decades. In the last few decades long-term funding for housing has come from three main sources: individual equity; debt finance and government grant/subsidy. So owner-occupation depends upon the owner occupiers' own equity together with mortgage finance; social housing depends upon debt finance and past and present government grant; while the growing private rented sector has been funded basically in the same way as owner-occupation. The main innovations have been in the range of debt instruments for both individual owners and social landlords and in UK and Scottish Government initiatives mainly in the intermediate low-cost home ownership sector which allow different mixes of equity, debt and the timing of payments (e.g., via shared equity and rent-to-buy models). Intermediate rental market products in Scotland are also beginning to play a role. The big gap is therefore the lack of either equity or debt finance for private rented investment.

The other major finance requirement is for development finance, which again comes mainly in the form of debt or developer equity, sometimes and increasingly supplemented by private equity. This is the financing area that has been most affected by the credit crunch with large scale overhangs affecting both developers and banks which has led to a very limited appetite to provide (or indeed take on) new loans. Here there appears to be growing interest among investors in directly challenging the developer route. An alternative is for the investors to work with the developers to the point where the certainty of longer term investment will de-risk the development stage to a point where debt finance will become available.

In the past, institutional investors have not been convinced that the yield available is adequate given the risks involved. Clearly this involves detailed examination at a project level, and typically financial models are used to (i) identify the scale and drivers of this gap, breaking down all the elements involved in making decisions to determine what they are prepared to pay for land and for the completed development (as described in detail in Annex D), and (ii) develop approaches to overcoming the gap by reducing costs and/or risk. Obviously not all of these will be internal to the project and may involve government support in the form either of subsidy or guarantees. Most models do not directly address the range of barriers identified in section 2 but rather concentrate on the core issues of return and risk – and therefore the preparedness of the private investors to be involved in the sector. These barriers were addressed in section 3.

### 4.1 Routes to financing additional rented housing

As stated above, the core of the financing issue is how to provide an acceptable risk/return package to the investor. Most of the solutions we examined are based on the provision of intermediate rather than market housing. This is mainly because they involve some element of government subsidy or guarantee, or a strong covenant to service the investment through a lease which guarantees income to the investor. As a result risks are reduced – but also rents are often held below market levels. Table 5 sets out the essential characteristics of four approaches to channelling more funding into new construction of rented housing, with examples of existing or proposed schemes. Annex E describes the operation of some of these schemes in more detail.

#### 4.1.1 Lease models

In these models, investors develop housing for social, affordable and/or private rent, which is leased to local authorities or housing associations to operate for a specified period. Institutions provide equity funding for development and receive income from lease payments. M&G and Bellerophon have both started to work with this model. One example is Stratford Halo where the properties have been purchased from the housing association by the institutional investor on a 160 year lease. The housing association in return holds the management contract and provides a guaranteed income. Thus risks associated with the income stream lie with the association. It is not yet clear whether such schemes can be attractive to investors without some form of guarantee associated with them.

#### 4.1.2 Direct purchase models

Perhaps the most straightforward models are those based on outright purchase. Here the developer produces housing, which is sold as an income-producing asset to an investor. Most of the models produced to date on this basis incorporate a government guarantee of the income stream to address investors' need for certainty about revenue. Proposals that use this approach include the Resolution Foundation's model and a proposed scheme by Halycon City Living in Glasgow.

Something similar is now operating in the former Olympic Village in London, where Qatari Diar Delancey bought 1500 of the units from the Olympic Delivery Authority and are soon to put them on the market at market rents without a guarantee – but with potential contractual exit arrangements in place. Some of our interviewees suggested that while this approach might work in London's high-demand environment, investors were more likely to require an income guarantee before they would consider investing in Scotland.

### 4.1.3 Aggregated bond models

In these models housing associations jointly participate in a bond issue (thus providing the size investors require), receiving long-term, relatively cheap funding secured on their existing assets. They can use the funds to finance new construction of social, affordable or market rented housing. Institutions participate as bond purchasers. To date such bonds have been used only to finance housing associations, although in principle they could work for large private providers as well. Large construction companies also issue own-name bonds. The UK-wide Housing Finance Corporation is the only organisation that has to date issued such bonds (since 1987), but Carduus is aiming to issue their first bond for Scottish housing associations.

### 4.1.4 Models that harness borrowing capacity of local authorities

In these models local authorities form joint ventures or LLPs with partners which lever in private sector investment alongside local authority borrowing. The Scottish Government mitigates the local authorities' financial risk via the mechanisms described in the table below. All or some of the units are eventually sold, most probably into owner-occupation.

**Table 5: Examples of four approaches to channel funding into rented housing**

| Name | Who provides fund? | Who owns & operates housing? | Security or guarantee | Will it finance new build rental housing? | How many existing deals? | Procurement/ state aid issues? | Does it provide aggregation? aggregation? | Issues |
|---|---|---|---|---|---|---|---|---|
| **LEASE MODELS**<br>Mechanism: Investors develop housing for social, affordable and/or private rent, which is leased to local authorities or housing associations to operate for a specified period. Institutions provide equity funding for development and receive I income from lease payments.<br>*Examples* | | | | | | | | |
| Bellerophon | Annuity fund | Joint public/ private LLP owns; local authorities or housing assns operate, with option to buy out private sector | No government guarantee – although argues this would make the scheme; local authority lease obviates void and management risk for LLP | Yes—social, submarket or market rented housing | Three sites in Wales with one further regeneration scheme recently announced | Procurement | Yes | Local authority or RSL needs to be comfortable with rental levels and adequate cost coverage for repairs |
| M&G | Investment fund | Investor owns; housing associations operate | No government guarantee, but housing association provides fixed income payments | Yes—affordable and private | One on this exact model in London | No | No - large minimum size | Investment only takes place after planning permission secured |

| Name | Who provides fund? | Who owns & operates housing? | Security or guarantee | Will it finance new build rental housing? | How many existing deals? | Procurement/ state aid issues? | Does it provide aggregation? aggregation? | Issues |
|---|---|---|---|---|---|---|---|---|
| **DIRECT PURCHASE MODELS**<br>Mechanism: Developer produces housing for affordable and/or market rent and sells a majority share/all of it to investors. Investors receive rental stream and housing associations or private sector managers operate the stock. Institutions participate as equity investors.<br>*Examples* | | | | | | | | |
| Resolution Foundation | Institutions | Investors own, housing associations operate | Looking for possible government guarantee on return | Model based on existing sites. Market & affordable. | None - demonstration exercise to show financial viability | None identified | Yes | |
| Halcyon City Living | Institutions | Investors own, developer and partners operate | Looking for possible government guarantee of income or shortfall | Yes - on identified sites. Market only. | None - still under development | None identified | No | |

| Name | Who provides fund? | Who owns & operates housing? | Security or guarantee | Will it finance new build rental housing? | How many existing deals? | Procurement/ state aid issues? | Does it provide aggregation? aggregation? | Issues |
|---|---|---|---|---|---|---|---|---|
| **AGGREGATED BOND FINANCING MODELS**<br>Mechanism: Housing associations jointly participate in bond issue, receiving long-term relatively cheap funding secured on their existing assets. They can use funds to finance new construction of social/affordable rented housing. Institutions participate as bond purchasers.<br>*Examples* | | | | | | | | |
| Carduus | Bond investors (city institutions) | Housing associations or their subsidiaries | No government guarantee; secured from associations' existing stock | Some - % of funding will go to refinancing existing debt, which in turn can facilitate new build | None yet | No | No | Proportion of funding will go to refinance existing obligations |

| Name | Who provides fund? | Who owns & operates housing? | Security or guarantee | Will it finance new build rental housing? | How many existing deals? | Procurement/ state aid issues? | Does it provide aggregation? aggregation? | Issues |
|---|---|---|---|---|---|---|---|---|
| **MODELS THAT HARNESS BORROWING CAPACITY OF LOCAL AUTHORITIES** Mechanism: Local authorities borrow money, usually from the PWLB, which they lend on to a Special Purpose Vehicle to build housing for affordable rent. SPV operates housing and makes loan repayments from revenues. Institutions could participate. *Examples* | | | | | | | | |
| Rettie Resonance | PWLB via local authorities | Public-private SPV; local authorities or housing associations operate | A capped Government contingency fund to mitigate repayment risk of local authority loans | Yes—mid-market | A few in Scotland | No | No | Profit deferred until sale of units |
| National Housing Trust – original model for councils and developers | Usually PWLB lending via local authorities on lending to LLP. | SPVs comprising the developer, Scottish Futures Trust and local authorities | Government guarantee of local authority loans – capital and interest shortfall | Yes—mid-market | Approval for over 1000 homes with further procurement underway | OJEU procurement process managed by SFT – state aid requirements managed by participating parties. | No | Developers' return on equity deferred until sale of units |
| National Housing Trust – council variant | Usually PWLB via local authorities | SPVs comprising SFT and local authorities | Government guarantee of local authority loans- capped interest shortfalls | Yes – mid market | 175 homes approved, more in pipeline | Local authorities manage any procurement required | No | No |

## 4.2 Government initiatives: Scotland

The traditional form of government support for housing construction in Scotland continues to be capital grants for social housing. In the past, such housing was concentrated on mono-tenure estates, but current policy requiring 25% social housing on all new developments is meant to change this pattern. Output levels have been proportionately high by UK standards, running at between 4,200 and 5,800 new homes over the last five years.

In addition to more general affordable housing schemes (usually encouraging low cost homeownership) there have been three specific programmes to spur new construction: GRO Grant (now rarely used), the National Housing Trust initiative (NHT) and now Help to Buy (Scotland). The current NHT scheme is described more fully in Annex D. It has gained considerable acceptance among developers, local authorities and housing associations. Many see it as far more acceptable than full market rental products, for several reasons—it delivers affordable housing, safeguards developers and allows them to complete large developments more quickly. However, some doubt has been expressed about how widely it can be pursued as it is not seen as viable in areas where the gap between market and social rent is relatively limited.

Help to Buy (Scotland) is a shared equity scheme launched by the Scottish Government in September 2013, aimed at purchasers of new build homes costing up to £400,000. The Scottish Government will take an equity stake of up to 20% of the value of the property, with the buyer's deposit and mortgage covering the remainder. No interest is charged on the government's equity stake. While there is no formal income limit, an affordability assessment is carried out and support is only offered to buyers who could not reasonably afford to purchase the home without the equity stake. Borrowers remain fully responsible for their mortgage payments and any shortfall in the normal way. To some extent Help to Buy (Scotland) provides an alternative to private renting for those who could reasonably afford a mortgage, However the initiative is cash limited and dependent on consumer demand, with funds committed for new-build completions up to end of March 2016. There are similar schemes operating in England and Wales although the details vary.

## 4.3 Government initiatives: UK-wide

The UK has a range of initiatives to support the recovery of the new build market, mainly in the form of guarantees.

### 4.3.1 Help to Buy Guarantee Scheme

The UK-wide Help to Buy Guarantee scheme launched in October 2013, offering support to lenders to provide a range of mortgages at up to a 95% loan-to-value for homes worth less than £600,000. Depending on the size of the deposit, the UK government will then guarantee to the lender up to 15% of the property's value in return for a fee. Lenders are able to choose which sections of the market they will support (i.e., new build, existing homes and/or remortgages); what loan-to-value ratio they will employ and when and how they will phase participation in the scheme.

### 4.3.2 The Affordable Rents Guarantee Programme

This uses the UK Government's fiscal credibility to reduce the cost of borrowing for non-profit registered or community-led housing providers, as well as to attract investment from fixed-income investors seeking a stable, long-term return on their investment without exposure to residential rental property risk. Affordable Housing Finance Plc (AHF), a subsidiary of The Housing Finance Corporation, has signed an exclusive licence with the Secretary of State for Communities and Local Government to offer guaranteed long-term debt to registered providers that develop new affordable rental properties. This programme has been underway since July 2013 and applies across the whole of the UK. It should significantly reduce the cost of funding and so increase housing associations' capacity to expand output levels of both social and affordable housing. However it will do nothing directly to support equity investment from institutions that have no requirement for debt.

### 4.3.3 The Private Rented Sector Housing Guarantee Scheme

This scheme is intended to support the building of new homes for the private rented sector across the UK, offering housing providers a direct UK Government guarantee on debt they raise, mainly in the form of bonds, to invest in new privately rented homes into the longer term. This will help to reduce their borrowing costs, increasing the number of homes they can afford to provide.

The guarantee is designed specifically to attract investment into the private rented sector from fixed-income investors who want a stable, long-term return on investment without exposure to residential property risk and who wish at least in part to use debt finance. The guarantee applies to that debt finance. Initially the Department for Communities and Local Government will assess applications for schemes in England to determine whether they comply with scheme rules, can demonstrate a solid management structure, suitable asset cover, a viable exit strategy, robust rental demand, and are clear on where and how they will raise the debt.

All of these UK-wide schemes either directly reduce the cost of borrowing or increase access to finance - for the mortgagor, the housing association or the private investor. That for housing associations directly impacts on schemes aimed at providing affordable housing. The scale required for the private rented sector guarantee puts it outside the reach of current private rental schemes in Scotland, but aims to support large scale new investment in the sector (although some aggregation of projects may help overcome this barrier).

## 4.4 Government initiatives: England only

There is only one current UK Government scheme directed at the private rented sector which is England only and does not have a similar scheme operating in Scotland. It directly addresses the issues of funding and risk associated with the development stage of providing new investment in private renting. It may provide a helpful example for Scottish policy makers. An earlier scheme introduced by the GLA has also been included as a forerunner of emerging schemes.

### 4.4.1 The Build to Rent Fund

The Build to Rent Fund is aimed at supporting the development of new purpose-built privately rented homes in England. In particular it will provide 'off the shelf' investment opportunities to longer term investors, reduces financing costs to developers and helps takes the risk out of building homes to let. The Fund is a fully recoverable commercially priced loan – thus involving no state aid – which can be used to fund the purchase of land, construction costs and management. Once the scheme is fully let the developer must sell on its interest or re-finance and repay the loan/equity. The fund will also be used to build innovative demonstration projects to show what a more professional, larger scale private rented market might look like. The original budget of £200 million has been increased to £1 billion. Some developers we spoke to said that they had already been considering production of PRS-specific housing before the introduction of the Fund and the Build to Rent initiative offered an incentive for them to get into the business. Again, this will do nothing directly to support equity investment from institutions that do not require debt.

At the present time there is no similar scheme in Scotland to provide market-priced finance to enable development. It would be within the Scottish Government's powers to introduce something on similar lines.

### 4.4.2 Greater London Authority partnerships

The first major attempt in the UK to bring institutional investors directly into new build private renting in modern times was undertaken by the Greater London Authority in the mid/late 2000s.

The GLA identified several large sites where public land was available and attempted to develop partnerships between the main stakeholders to fund large-scale development. Only on one site was a partnership put in place, but it did not progress to the point of construction. This was partly because of the financial crisis but more fundamentally because yields could not be guaranteed, and therefore the initiative failed.

## 4.5 Conclusions

In this section we have confined our discussion to models, whether private sector or government-led, that aim to reduce risks and increase yields to the point where investors are prepared to provide the finance to enable new private housing development to proceed. Only one of these schemes directly addresses the costs and availability of development finance. The others look at different ways of encouraging investment through guarantees, subsidies and contractual arrangements which mainly aim to provide a predictable income stream for investors prepared to commit to the longer term.

Apart from the mid-market rent programme, all of the government sponsored initiatives have only been in place for a very short time. Most of the financial models, again with the exception of the original NHT initiative, are also work in progress. Thus there are large numbers of untried initiatives in the innovation space. The key questions are therefore which ones are winners and which barriers remain.

It is worth noting that subsidies and guarantees often bring into play either European Union procurement procedures, when public bodies are involved as providers, or state-aid issues when public bodies are not involved. Both tend to increase the costs of administration.

The evidence set out above suggests that channelling institutional finance into private renting and into a segment of the housing market providing high quality housing for a wide range of households is highly desirable. It also suggests that it is not a quick win. Indeed as Table 6 makes clear, there is a range of market, affordable and social rented housing approaches which are already embedded in policy and finance.

Everyone agrees that this is the best opportunity in a lifetime – and there are stakeholders in all categories prepared to make it work. The objective must be to harness this enthusiasm as quickly as possible. The benefit that could be achieved from encouraging demonstration projects in the current environment is clear. Our recommendations seek to provide some ways forward.

### Table 6: Possible channels for increasing new investment in rental housing in Scotland

| Type of new housing | Advantages of targeting support here | Obstacles | Who could take action and how |
|---|---|---|---|
| Intermediate rental including NHT | Small but working well<br>Relatively well understood and now extended to long-term rent<br>Easy for smaller developers and partnerships to take part | • Belief that only works in a few areas – BUT gapsbetween even LHA and social rent appear quite large in many places<br>• Procurement and administrative costs high | Government: improve statistics on rents and types of demand at local level; provide funds as for social housing<br>Homes for Scotland could provide information good practice or indeed a prospectus to help new developers enter market |
| Buy-to-let | Well established but hit by credit crunch and confidence<br>Small scale within owner-occupation sites, so expands demand where capital gains expected<br>Worked well when credit readily available; did increase output and modify built stock, at least in England | • Credit still limited<br>• Demand depend on gap between Mid-Market Rents and market rents<br>• Significant issues around management<br>• Landlords' desire to realise capital values affects sustainability | Financial market<br>Government: identify gaps in market<br>Local authorities: determine densities/ types of unit etc<br>REITs one way of maintaining properties in the rental sector. Currently UK Government to review |
| Student housing | Now a well-established model, often with university partnership and usually in central urban areas. It shows new markets can be created | • Depends on growth of HE sector<br>• Require good management and local authority permissions<br>• Local antipathy in some areas | Working group to clarify interest from institutional investors as well as RSLs and property companies with management experience |
| Market rent for young professional and shorter term migrants and mobile households | Higher density small unit developments in high demand areas Few good examples as yet | • Desire among some investors for guaranteed income streams<br>• Uncertainty about management costs<br>• Competition from commercial sector – apartment hotels etc | Local authority: appropriate regulations on density<br>Demonstration projects by government and other stakeholders<br>Private sector to address development funding problems: self funding, employer or institutional funding |
| Large scale new build private rented sector housing | Plenty of investor interest could be unlocked with guarantees or subsidy<br>(i) Build to Rent<br>(ii) Demonstration sites with covenanted PRS (or equivalent)<br>(iii) Funding guarantees for ownership | • Competition for sites with owner occupation<br>• Development finance at reasonable cost and other ways of de-risking the development stage;<br>• Need for benchmarking data<br>• Need for management platform<br>• Intermediary required to bring developers and institutions together | Government: Build to Rent fund; guarantees for RSLs/RPs and private borrowing<br>Government and industry: initiatives to improve data; create functioning projects to reduce risk aversion; designate champions (including institutions) involved in development<br>RSLs: act as intermediaries |

## 5 Conclusions: bringing the evidence together

### 5.1 Reasons to grow the rental sector

There are at least four reasons that this is the time to grow the rental sector, and especially the private market sector:

- Household growth is projected to increase more rapidly than in past decades. Reasonable assumptions imply that well over 20,000 dwellings per annum will be necessary to keep up with requirements, of which perhaps 7,000 – 8,000 could be rental units;
- Output levels are particularly low but there is considerable capacity to increase activity as well as the appetite to look at new ways to achieve the necessary investment;
- The private rented sector has been growing rapidly, not only for cyclical but also structural reasons. This points to the need to develop a higher-quality, more professional sector to meet continuing demand from both younger and more mobile employed households and from family households looking for secure homes; and
- The current constraints on mortgage supply and access to mortgages will generate sustained demand for a high-quality, accessible private rented sector. Opening up institutional investment leverages in new sources of funds matched to an asset class with long-term potential.

This environment provides the best opportunity in a lifetime to increase private investment in housing in general (and in private renting in particular) and to bring about radical change in the quality of provision. This is a vision worth working for.

### 5.2 Problems with current patterns of market supply

The current pattern of provision of market housing in Scotland, as in the rest of the UK, is based on owner occupation - itself a sector under pressure and where finance is constrained. Land prices therefore incorporate expectations of capital gains which are not usually included in long-term rental yield assessments, so buyers who would use the land for rental housing find it hard to compete. The most successful rental model to date has been buy-to-let, in part because these investors make the same assumptions about capital gains as owner-occupiers do, and in part because the stock they purchase is usually equally suitable for home ownership – and indeed the expectation is that it will be transferred into owner-occupation at some stage. Government-supported intermediate housing follows a similar trajectory: it either goes directly into owner-occupation or starts out as sub-market rental products - many of which eventually will be sold into owner-occupation.

In some parts of the country rental returns may be equal to or exceed those for owner occupation, but these are areas where capital gains are not factored in because of lower demand. These are not areas where new build private renting can flourish. This suggests either that investment specifically for private renting needs to be purpose built on land and at a scale that is particularly suited to the rental market (and so can compete against owner-occupation), or that some form of government support is required to make it viable.

### 5.3 Student accommodation – a successful model

The most successful model developed over the last decade for creating new build accommodation was student housing - although the strong investment in the sector was an unintended by-product of a government initiative, the Business Expansion Scheme, which incentivised individuals to invest by providing an exit strategy. In response to this opportunity the finance industry, together with universities and in some cases housing associations, developed a risk-free model which was then translated into a form suitable for institutional investors.

In Scotland the BES scheme led to the construction of purpose-built student accommodation and facilities-management arrangements, especially in Edinburgh and Glasgow. Originally, universities provided the land and took the risks, while investors generally purchased completed units and received an indexed rental stream backed by university assets. These conditions have now been relaxed and there is considerable institutional investment in new student accommodation without university or housing association support – but with the benefit that student housing is seen as satisfying housing need so there is no S75 requirement.

**This model suggests three important lessons:**

- First, this form of investment came very close to the well-understood commercial property model, where there is a long-term contract, the investor receives a certain income which rises with prices (or, ideally, incomes) and capital gains are not part of the equation;
- Second, it takes a long time to develop a market from one where government ensured a near-riskless income stream to a mature freestanding market that depends on demand (even if it is seen as near certain to increase) and incomes that rise with economic growth;
- Third, government incentives can provide an opportunity for a new market to demonstrate potential.

It is only in the last few years that mainstream institutions have put in significant funding. Investors have relaxed their requirements, and early government incentives have now given way to a mature market.

### 5.4 What are the barriers?

Institutional investors, as suggested above, ideally want guaranteed returns which rise automatically over time. Residential property has the immense benefit that net rents can generally be expected to rise with incomes – exactly what annuity funds in particular are looking for.
On the other hand, institutions have almost no experience of the asset class, their management systems make it difficult to bring in new assets, and the necessary data for benchmarking are not readily available. Some of our interviewees noted that 'a champion' within an organisation could change institutional attitudes, and cited real evidence of increasing involvement in the sector. However, the data issue remains crucial – IPD is the only source of information available about existing institutional (including housing association) investment. The database is inherently London-centric and so far includes only a very small number of Scottish units.

Looking at the process by which development is initiated, constructed and transferred into ownership, the three big areas where returns need be increased and/or de-risked are:

(i) the costs to developers of obtaining land with planning permission, and financing land purchase and construction;

(ii) the risks and costs around transferring developments into longer-term ownership, and

(iii) the size of the gap between gross and net rents, which depends on management costs and quality.

The financial models emerging are based mainly on

- public ownership of land, public/private partnerships for development and leases and contractual restrictions to ensure long-term private rental;
- housing associations or local authorities bringing near-guaranteed income, basic scale and experienced management to the contracts with institutions; and
- initiatives from sovereign wealth funds, overseas pension funds and a small number of leading UK institutions where there are senior managers who see an important opportunity.

The Montague Report came at a particularly important time. There was growing interest by institutions but many outstanding issues, and the report succinctly spelled out these issues and made recommendations that were quickly followed up by the UK Government. The resulting initiatives have concentrated on ensuring finance for the development process at market rates through the Build to Rent Fund in England, and providing guarantees to reduce the costs of borrowing to support long-term investors across the UK. The report also led to the appointment of a task force which aims to address any further barriers as they emerge.

There has been very little done directly to address the problems of ensuring availability of suitable sites, transferring properties at scale from developer to long-term owner or the lack of high-quality management platforms. The issue of site availability has risen rapidly up the agenda even during the period of this research. There are different approaches emerging to the process of property transfer, including developers maintaining ownership at least for a period, early agreements with institutions which help reduce the cost of funding, and institutions themselves leading on development. So far most of the solutions on management involve housing associations – but they have their own issues to address, and their experience is of a very different type of management.

In the Scottish context there is undoubtedly a similar level of enthusiasm and activity among stakeholders, but there are some important differences from the rest of the UK. These include:

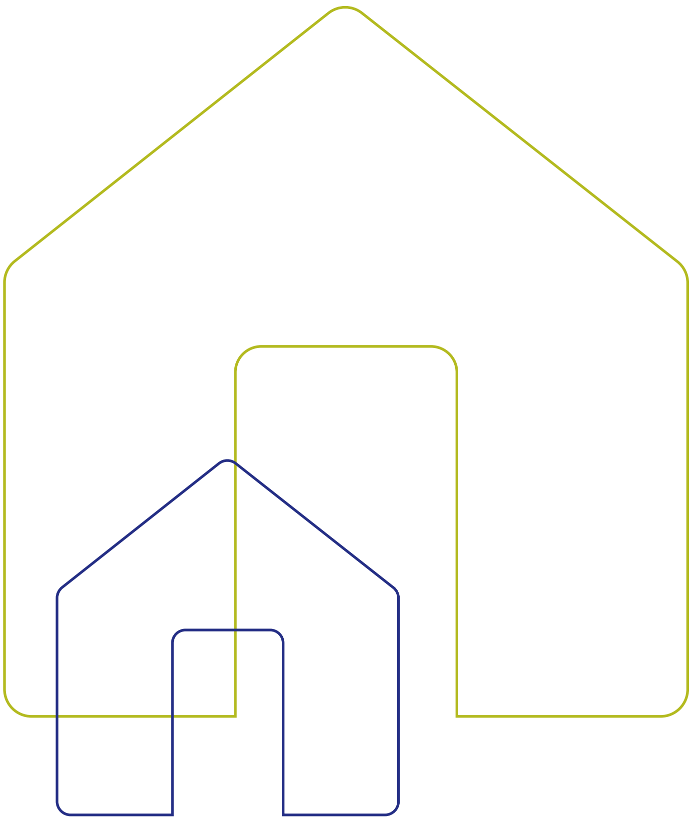
(a) *long-term demand*. Before the financial crisis, total output levels were running at over 25,000 homes per annum, which more than kept pace with household formation. Social and affordable housing completions reached a peak of over 8,000 units in 2009-10 and were over 6,000 in 2012-13. If in future capital grants remain generous, mid-market initiatives become more embedded in the system (which of itself would be highly desirable as they help meet the requirement for lower-subsidy housing) and Help to Buy effectively supports increasing investment in owner-occupation, there may be relatively little interest - either from builders or consumers - in the expansion of new build private rental outside the biggest cities. This is not a desirable outcome. There clearly is a need for purpose-built private rented development to meet structural changes in demand and to support economic growth and a flexible labour market;

(b) *scale of development*. Most Scottish builders are relatively small and even if they work together on a development probably will not be able to generate the scale necessary on a single project to attract institutional investors. This suggests some potential for aggregation across sites;

(c) *identification of sites*. As yet there has been little interest from local authorities and other public agencies in specifically supporting private renting through the identification of land and its potential allocation to mixed development including private renting (a role currently undertaken in England by the Housing and Communities Agency); and

(d) *Scottish Government support for private renting*. The Scottish Government has not indicated that they are considering any equivalent to the English Build to Rent Fund. At the same time, perceived uncertainties around some aspects of legislation are negatively impacting on some stakeholder attitudes.

Yet there are many reasons for optimism. Land is available and housing supply is more responsive in Scotland than in England; there are many stakeholders with particular interests in supporting the Scottish economy and others looking for opportunities to invest especially in the major cities; and there is a strong sense of partnership and capacity to coordinate, reflecting the scale of the country. The creation of a few successful operational schemes will show that barriers have been overcome. What is needed now is a plan of action and the will to carry it forward.



## 6 Recommendations

There are a number of stakeholders that need to be proactively involved in ensuring the successful extended development of the rented sector in Scotland. They include at least the following: builders and developers, financial institutions, property management and service providers, housing associations, trade bodies, local government and the Scottish Government. All already have an active interest, but most do not see developing a new model of private renting as their first priority. This has to change if the opportunities now becoming available are to be realised.

### 6.1 Recommendations

The recommendations are ordered by the main issues that need to be addressed: improving information, smoothing the path for development, engaging institutional interest and providing high-quality management.

To deliver on these recommendations will require commitment by all stakeholders although where possible we have identified the appropriate leadership.

The first four recommendations address issues around how better to **inform** these stakeholders of the opportunities that could exist or already do.

#### Recommendation 1

There should be a **small focused and time-limited working party set up**, possibly led by the development industry and facilitated by the Scottish Government. Building on this report, it would identify and monitor pinch-points that are holding back development and institutional involvement, recommend how these could be overcome and inform stakeholders about mechanisms being employed.

#### Recommendation 2

The working party should identify a **Private Rented Sector Champion** who would chair the group and take forward the initiatives it identified as necessary to enable potentially viable projects to reach fruition.

#### Recommendation 3

An acceptable residential benchmark index for Scotland needs to be put in place. The IPD index is the only suitable index available, but it includes only a few Scottish residential properties. IPD is working to extend its coverage across the UK, and institutional owners, landlords and housing associations need to take the lead in **providing data to IPD**; negotiating with them about what is necessary to generate a **Scotland- specific index**; and agreeing with IPD how more broadly located property information could be of value to decision-makers in institutions and housing associations.

#### Recommendation 4

A more detailed analysis should be undertaken of **who is in the market and intermediate rented sectors and why** to support better understanding of future new construction market opportunities. Such research might be supported by the construction industry and/or interested institutions as well as by the Scottish Government.

The next seven recommendations relate to the housing development stage.

#### Recommendation 5

The valuation of rented housing means that developments of rented housing often cannot outbid owner-occupied housing. In addition, planning risk and the need to identify appropriate sites in suitable areas where private renting has a comparative advantage must be addressed. We recommend that local authorities, initially in Edinburgh, Glasgow, Aberdeen and Inverness, **make suitable demonstration sites available for residential rental development that will give the opportunity for large scale institutional investment.** The local authorities could act as equity stakeholders of that land and host competitions among developers and investors to provide higher-density new developments in central city areas with a mix of tenures (including e.g., owner-occupied, market rented and affordable homes).

**Recommendation 6**

In this context it may be appropriate for the Scottish Government and local authorities to consider effectively **supporting a limited number of initial projects to demonstrate demand potential for all involved.** Whilst it would be difficult to use funding for such a role it might be value for money in that it could demonstrate the social value of building a professionally rented sector and would allow the Scottish Government to have a say in the standards being applied.

**Recommendation 7**

The issue of how to **contract developments to ensure properties remain in private renting into the longer term** must be examined. We recommend that the Scottish Government leads on more detailed discussion on how the 2010 and 2011 Acts can best support the use of long leases. A study of whether and how a form of 'covenanted' private renting as being tested for publicly owned land in England might be made operational within Scottish law.

**Recommendation 8**

Local authorities should carefully consider how they might **better evidence the need for private rented housing within their Housing Need and Demand Assessments**. We recommend that local authorities strengthen their analysis of demand across tenures, identifying private renting separately where appropriate.

**Recommendation 9**

**Local authorities should consider exercising more flexibility in the determination of S75 and similar developer contributions**. We do not support the idea that market-rented housing should be treated as if it were affordable, but we recommend that local authorities should consider exercising flexibility in assessing S75 and similar developer contributions from rental housing developments addressing particular needs such as for higher density provision for younger households as has been done with respect to student accommodation.

**Recommendation 10**

There are specific opportunities to expand the student accommodation and young professional sector. We recommend that the working group enter into discussion with universities, employers, local authorities, Homes for Scotland and potential providers to come up with a **detailed building specification for high-density accommodation for students, young professionals and mobile singles**.

**Recommendation 11**

While it is too early to say for certain that the Build to Rent Fund has proved to be value for money in England it has undoubtedly brought new players into the market and raised the possibility of large scale investment becoming more readily available for purchase by institutions. We therefore recommend that **the Scottish Government consider creating its own market-priced Build to Rent Fund**.

The next five recommendations address the issue of how to **match institutional investment with new development**.

**Recommendation 12**

In order to raise awareness of the opportunities for institutional investment in Scotland we recommend that the working party's role includes **the development of a prospectus to attract institutional investment in rental housing in Scotland**.

**Recommendation 13**

In line with this approach we recommend that Scottish Financial Enterprise (SFE) set up a **Sector Policy Group to explore the potential for the industry to engage with investing in this sector** and to secure the pre-conditions for it to do so.

**Recommendation 14**

Developers and institutions, especially those who have already been involved in discussions with government and other stakeholders, should take an active part in **taking forward the sites identified as suitable demonstration sites available for residential rental development under Recommendation 6 to completion and transfer**.

**Recommendation 15**

Aggregation could be one way of bringing institutional funds into both market and intermediate through the transfer of single developments into diversified portfolios. We therefore recommend that **Homes for Scotland develop its role as a potential aggregator in partnership with the industry**.

### Recommendation 16

The private rent guarantee scheme which is still in the early days of development in the English context is a UK-wide scheme. It involves state aid and therefore provides a subsidy to investors who wish to use debt finance for purchase. This may offer a new source of funding for a range of institutions. We recommend that the **construction sector and landlords in Scotland consider this route and pursue applications where an opportunity arises to do so**.

The next two recommendations relate to barriers with respect to **management**.

### Recommendation 17

The costs of management and maintenance and their effect on the gap between gross and net yield remain a serious problem area. What little evidence there is suggests that these costs are above average in Scotland. **A study of the reasons for high management costs and how they might be reduced is required**. Housing associations, management agents and consultants involved in providing management services should be encouraged to examine good practice as well as investigating whether management of purpose-built provision costs less.

### Recommendation 18

Equally there needs to be better understood and more transparent means of ensuring that consumers can expect professional standards of management. The working group should consider how best to **recognise and encourage good management practice** in the sector without adding to the regulatory burden on landlords.

Bringing these different elements together is a major task involving both vision and detail. Recommendation 19 sets out a starting point.

### Recommendation 19

We do not make any recommendation suggesting that one specific model is the best approach to developing a professional private rented sector. The evidence of developments across the UK is that there are many different approaches which will work in different circumstances and it is far too early to rule out possibilities. We therefore recommend that **the working party takes initial responsibility for cataloguing and assessing existing and proposed financial models for additional provision of rented housing across the UK**.

The final recommendation provides a word of warning and addresses the issue of maintaining **continued confidence and competitiveness** in the development of a professional private rented sector at scale.

### Recommendation 20

One of the most important messages from this research has been the **need for stability in the policy, taxation and regulatory environments**. Although there is enthusiasm and considerable activity, there is also fragility. We therefore **recommend that the Scottish Government should ensure that all parties are fully aware of the very positive approaches taken in legislation with respect to the 20-year rules and the introduction of Land and Buildings Transaction Tax in April 2015 (the successor to Stamp Duty Land Tax). There also needs to be a clear commitment to ensure that the tax and regulatory environment does not negatively differentiate Scotland from the rest of the UK**. The value of continued commitment to maintaining a predictable transparent regulatory environment cannot be overstated.

## 6.2 Developing a road map

In the next stage, the conditions and structures that will enable the recommendations to become fully effective need to be put in place. The road map of key steps and actions to be taken is as follows:

1. Setting out the opportunities and aspirations and a broad plan, along with timeline, and putting in place the working party and Champion to take the plan forward
2. Building the information base, including index, research and additional data, and developing a greater understanding of the marketplace at both national and local levels
3. Writing the prospectus and the investment profile and building a sustained and targeted public relations process around them
4. Engaging with institutions and Scottish Financial Enterprise
5. Developing and launching demonstration PRS projects
6. Developing management standards in consultation with investors and managers
7. Launching new schemes

## Glossary and definitions

### Acronyms

| | |
|---|---|
| AHF | Affordable Housing Finance plc |
| AST | Assured Shorthold Tenancy (England) |
| GDV | Gross development value |
| HA | Housing association |
| IPD | Investment Property Databank |
| LA | Local authority |
| LBTT | Land and Buildings Transactions Tax (Scotland, forthcoming) |
| LHA | Local Housing Allowance |
| LLP | Limited liability partnership |
| NHT | National Housing Trust (Scotland) |
| OJEU | Official Journal of the European Union |
| PRS | Private rented sector |
| PWLB | Public Works Loan Board |
| RP | Registered Provider (England) |
| RSL | Registered Social Landlord (Scotland0 |
| S75 | Section 75 of the Town and Country Planning (Scotland) Act 1997 |
| SAT | Short Assured Tenancy (Scotland) |
| SDLT | Stamp Duty Land Tax |
| SFE | Scottish Financial Enterprise |
| SFT | Scottish Futures Trust |
| SPV | Special purpose vehicle |
| SST | Scottish Secure Tenancy |
| THFC | The Housing Finance Corporation |

| | |
|---|---|
| **Market rented housing** | Dwellings let at market-clearing rents, whether owned by private or registered social landlords through profit-making subsidiaries |
| **Intermediate rented housing** | Dwellings let at sub-market but above social rent levels, usually provided with the help of public subsidy (which may be in the form of grant, loan, guarantee or waiver of receipts). |
| **Social rented housing** | Generally, social housing is rented housing provided by councils and registered social landlords, normally on a Scottish Secure Tenancy (SST). |
| **The private rented sector** | Dwellings that can be let at market rates. Traditionally defined by private nature of landlord, but these now include profit-making subsidiaries of social landlords. |
| **The rented sector** | Dwellings let by all types of landlord – local authorities, registered social landlords and private owners. |

## Annex A: The brief from Homes for Scotland

### Background

The banking crisis and credit crunch of 2007/08 has resulted in a structural change in the ability, attitude and appetite of many banks to fund new housing development, to the point that many simply either cannot or do not wish to currently invest in the housebuilding/construction sector. The consequence of this change is that fewer homes, of all tenures, are able to be purchased or built.

In contrast, housing need is growing. National Records of Scotland forecast that, to meet population growth and household formation, 450,000 new homes are required between now and 2033. This equates to an average of 22,500 new homes per year. In 2011, only 15,000 new homes were completed and the full year forecasts for 2012 suggest little change on this total annual output.

**The challenge, therefore, is how can we meet Scotland's housing needs whilst access to traditional forms of finance and funding is constrained? Attracting large-scale institutional investors into allocating funds for the development of new homes for rent is a major opportunity that would stimulate growth in the economy, the housebuilding sector and deliver a much needed boost to jobs in the construction sector and service industries.**

The project Steering Group has now been formed and the next stage is to undertake the detailed analysis of the opportunity and commence with the design of possible solutions.

### Aims & Objectives

3.1 **Project Aim:** "Supporting homebuilders to increase the supply of new homes in the rented sector in Scotland"

3.2 **Research Objectives:**

- To confirm and quantify our existing knowledge and understanding of the known barriers to this opportunity. Identify any new barriers.
- To identify, test and evaluate possible solutions and remedies to these barriers, with stakeholders

We specifically want to clarify and confirm our understanding of the perceived barriers and opportunities that exist to bring in new sources of finance or approaches

that would leverage-in additional funding for the construction of new homes for rent. We are adopting a 'tenure-neutral' approach to the project and are interested to investigate and consider all opportunities – social/affordable, mid-market and private rented.

For the purposes of this project, we are assuming that conventional bank finance is excluded, given that this traditional source of funding is well-understood, both in terms of its process and limitations. Instead, we wish to understand more about new or potentially new sources of funding or financial models that could provide incremental increased net investment both in terms of their viability and potential enablers.

### Annex B: Interviewees: Categories and numbers

| Category | Number of interviewees |
|---|---|
| **In Scotland** | |
| Financial institutions, advisers and those working with financial models | 4 |
| Scottish Government policy makers and local officials | 8 |
| Existing large landlords | 7 |
| Developers and builders | 10 |
| Trade associations and academics | 2 |
| **In London and elsewhere** | |
| Financial institutions, advisers and those working with financial models | 8 |
| UK and local government policy makers | 6 |
| Existing large landlords | 4 |
| Developers and builders | 4 |
| Think tanks, professional organisations and academics | 7 |
| **TOTAL** | **60** |

## Annex C: The development of the private rented sector in Scotland: Historical context

### Pre-war

The heyday of institutional – or rather company – investment in private renting was before the Second World War (Hamnett and Randolph, 1988). The companies involved included large landowners, pension funds and property companies but also industrial and infrastructure firms that diversified into residential property or provided housing for their own staff (25% of the PRS in the early 1970s was for employees, and that was mainly built before 1939). Private renting was the majority tenure, so there was demand from employed households who had expectations of income growth but few other housing options.

The 1930s changed this picture somewhat by increasing access to owner-occupation. Planning and policy were pro-development. There was very large-scale greenfield development, mainly ribbon and suburban housing where mixed tenure development was appropriate. In urban areas and especially in London the mansion block offered a simple, good quality product for investors. Rent controls put in place in 1915 (Englander, 1981) were being unwound and new investment in the sector was increasingly unaffected by these controls. There were large numbers of investors so it was easy to transact – although company investors generally kept their holdings into the long term. They managed the properties themselves or used specialist managers. The relevant alternative investments were direct investment in other sectors; property companies also invested in commercial. PRS was an apparently low-risk investment with a clear and secure income stream; easy access to new projects; costs under control; and few alternatives for most tenants.

### What changed?

The Second World War led to the reintroduction of rent controls, which reduced returns to landlords, closed down their exit opportunities and made them less able to maintain the stock. This was followed by the demolition of large swathes of housing as a consequence of slum clearance and the municipalisation of parts of the remaining stock. The post-war growth of social housing and easier access to owner-occupation created wider housing opportunities for potential tenants. Subsequent deregulation and leasehold reform (and the reorganisation of residential portfolios by employers) opened up the possibility for landlords to exit by selling into owner-occupation; at the same time other investment opportunities increased.

The result was a private rented market which mostly housed young and mobile households needing easy access to homes and those who had no other options (supported from the early 1970s by housing allowances). Almost all employer-owned housing was sold off (Hamnett and Randolph, 1988) and new build was concentrated in the owner-occupied market, meeting the requirements of lenders and government. There was little or no space for new private rented investment. Indeed the slow demise of the private rented sector was widely anticipated. Whitehead and Kleinman (1986) provided simple estimates in 1986 suggesting the sector would fall to 7% by 2000.

The creation of a new private rented market: initial steps

### Student accommodation

The Business Expansion Scheme (BES), introduced in 1988, provided tax incentives for individual investors in small companies to invest in rented accommodation. The scheme produced some 80,000 dwellings (Hughes, 1995). It provided a clear exit strategy for individual investors. In practice it was used mostly for student accommodation and other low-risk opportunities (including housing associations). It attracted large-scale build and management entrants into the student accommodation market, and there were some sales into institutional portfolios.

The product was de-risked because universities acted as guarantors; because buildings and services were standardised; and because contracts provided a guaranteed income stream. Other initiatives involving the provision of mainstream privately rented accommodation were less long lasting; many of the companies were dissolved and the properties transferred to owner-occupation.

### Buy to let

The growth of the buy-to-let market from the mid-1990s came out of an initiative by the Association of Residential Letting Agents (ARLA) and supported by lenders. The aim was to offer an innovative mortgage product that would allow private investors to buy properties for renting out. This created welcome market diversity at the same time as other market factors led to increased demand. The market expanded rapidly and was supported by the shift in new build toward flats and higher density development. Buy-to-let investors provided pre-sales which helped developer cash flow. The credit crunch of 2007/08 significantly reduced the supply of credit for buy-to-let mortgages but this is beginning to recover. At a UK level, buy to let now accounts for about 10% of gross mortgage lending and is at its highest level since mid-2008 (Paragon, 2013).

Buy-to-let investors want an investment they understand and which to some extent they can control. Most of them seek a total return including capital gains. To keep costs low, most (estimated at 55%, ibid) manage and maintain the properties themselves. The types of product required (either small blocks of flats or a normal owner-occupied product) are relatively easy for planners to accept and simple for developers to build. With debt finance and a well-defined exit strategy (generally sale into owner-occupation), on a per-unit basis buy-to-let investors can outbid institutions and sometimes owner-occupiers.

### Accidental/reluctant landlords

The credit crisis and recession generated some accidental landlords who cannot or do not want to sell in the current environment although as the market has eased this group can be expected to shrink. An unknown proportion of the growth in the sector in Scotland from 6% at the turn of the century to 11% in 2010 (Scottish Government, 2013) may be of this type, and the dwellings may transfer back to owner occupation if conditions change. This, and the fact that such landlordism generates little if any additional investment, is a core reason for the emphasis on developing a more sustainable sector based on intentional landlords. The Scottish Government estimates that only 2% of private rented housing in Scotland is held by institutional investors--i.e., little more than 5,000 units.

## Annex D: Decision-making by owners and developers: financial modelling and risk

Much investment decision making is based on rule of thumb or intuition. However, the basis for any large scale involvement in the private rented sector by institutions must depend on formal financial modelling processes and the rates of return that can be actuarially compared to other opportunities.

The term 'financial model' means different things in different contexts. The term can suggest something complex, opaque and possibly proprietary, and indeed in quantitative finance, models are sophisticated mathematical exercises that deal with portfolio returns, option pricing etc. But in the property sector financial models have tended to be relatively straightforward. At its most basic, a model could be a simple spreadsheet (or even a column of figures) which allows the user to make calculations based on a set of assumptions about costs and risk. The outputs or results from the model depend on what the user is trying to determine. Most property models are designed to calculate potential yield to the long term owner and therefore how much they will pay to purchase the properties, or residual land value to enable the developer to decide how much to pay for the land.

Most stakeholders in the field use versions of yield as a decision-making tool, but even among property professionals there is no single agreed approach to how yield should be calculated, and therefore about the precise meaning of the term. The most basic formulation is annual income /asset price which is then compared with yields elsewhere. In this simple form it would generate optimal decisions only if the investment asset were held in perpetuity, with constant certain rents and costs and perfect markets. In this case returns would be the same as for owner-occupation and the comparator is simply the risk-free market interest rate. Not surprisingly, as decisions are actually being made in imperfect and uncertain worlds, the interpretation of yield depends on unspecified assumptions around future rents, costs and values as well as the individual organisation's cost of capital, expected return and attitude to risk.

This income yield (also known as current or running yield) does not include capital gains. However many PRS investors (although probably not pension funds) expect that the bulk of the return will be in the form of capital appreciation. When capital gains are included, the total yield calculation is total return (income plus capital gains) over asset price. Confusingly, in property development circles the word 'yield' may be used to mean either income yield or total yield.  Another term used in property investment is the 'all-risks yield', meant to reflect all the risks involved in an investment.  Even in discussions among professionals it can be unclear which definition is being used – let alone what is determining the comparator rate. And many investors interpret 'yield' to mean the internal rate of return (IRR), which takes account more directly of all expected changes in revenues, costs and values as well as a more detailed understanding of the return on the relevant alternative investment.

Equally these narrow definitions of yield do not directly address issues of inflation and rising rents over time. This is important because investors, notably annuity funds, are looking for returns which rise with income. In this context many professionals would look to include regular adjustment of rents by CPI or RPI.

To illustrate, we construct a simple model for yield accepting the assumptions of certainty, constant costs and revenues over time, perpetuity and neutrality between equity and debt financing. At this most basic level yield is a function of income (revenue less costs) and asset price. The equation can be stated two ways:

**Yield = Income / asset price OR Asset price = income / yield**

If we know income and asset price we can solve for yield and can compare it with other relevant opportunities; if the decision is about whether to bid for the property or land and we know income and apply a target yield, we can solve for the asset price that the decision maker would be prepared to pay. Whether that will be acceptable will depend on the alternatives available to the seller.

There are several subsidiary variables and calculations that go into determining income even in this simple form. An example is set out in Table D1.  Revenue comes from rents, while costs include management and maintenance, voids and re-let costs as well as, for instance, ground rent.

**Table D1: Example of the elements determining income from an investment in PRS property**

| **Overall equation:** Yield = Income / asset price OR Asset price = income / yield | | |
|---|---|---|
| **Main elements** | **Made up of** | **Subsidiary elements/ calculations** |
| Revenue | Annual rent *number of units | Number of units<br>Rent per unit<br>Annual rent increase |
| Costs | Voids | Average tenant length of stay<br>Average time to find new tenant |
| | Re-lets | Average cost of refurbishment between tenants<br>Cost of marketing |
| | Management | Property supervision, to include letting and running the property<br>Rent collection<br>Arrears and bad debts |
| | Other costs | Repairs and maintenance<br>Insurance<br>Service charge and ground rents<br>Utilities |

An investor would use a version of this to determine whether to invest in a hypothetical rented housing development. We assume here that this is a rental-only development that is fully let and that the revenue and cost streams are known. The investor's target yield (which would depend on returns available from alternative investments with a similar risk profile) and the known income stream could be used to calculate an asset price. If the investor could purchase the asset for this price they would invest; if the price were higher they would not. This is a development valuation – a mirror of the residual valuation – just calculating for a different unknown.

Looking specifically at investment in new-build property, it is then necessary to determine whether the developer would be prepared to provide the dwellings. In this context developers use residual valuation calculations to determine what price they can pay for land, given assumptions about what can be built on that land. While the principles are the same, some of the assumptions differ between developers and institutions – so their calculations might not reach the same conclusions despite being based on similar information.

The first stage of the development process is land purchase. A developer will expect to spend on land an amount equal to the final value of the development, less costs (including financing) and developer profit—this is known as the 'residual land value' method of pricing.

1, Investment Property Databank (IPD) figures give an overall average cost of 34.3% of gross income for their sample of private rented properties (and 47.5% in Scotland and the North of England). Some of those we interviewed believed the gross-to-net difference could be reduced to perhaps 25% and even in some circumstances somewhat lower. However this would likely be possible only for certain types of units in concentrations big enough to ensure economies of scale.

The developer must therefore determine the final value of the development and the costs of producing it, given the required level of profit. The overall equation is:

**Residual land value = Gross development value – cost of production – developer profit**

Again, each component of the equation is made up of subsidiary elements (even the developer profit may be part funding cost)—see Table D2. If the property is to be used for rental purposes, gross development value is the capitalised value of the rental income from the units.

For the development to be used for renting this should equal the capital value that the highest bidder is prepared to pay. In many instances therefore the relevant valuation will be based on owner-occupation. In others a mix of tenures may give a higher value. Only if renting gives the highest expected value will this be the use to which the developer will put the land. (By implication many of the incentives necessary to ensure that land is available for rental provision must address the issue of different approaches to valuation.)

***See Table D2:*** *below.*

The costs of production include construction costs; associated land costs (including most importantly any S75 contributions – see discussion on page 14); fees; and the cost of getting the development up to full occupancy on first letting. In the first instance we assume that planning permission is a given—that is, there is no risk or uncertainty about the possibility of developing the site.

If we are solving for residual land value the final element is required developer profit, which is usually expressed as a percentage of gross development value (GDV). In principle it should be the best alternative use for the capital and expertise employed. However, many developers employ rules of thumb to calculate the margins they need to achieve, including their costs of capital, whether internal or from the market. The term 'profit on cost' refers to the profit on all costs including land; developers told us that their required profit on cost is about 20%.

2, Alternatively, if the price of the land is given, the equation can be restated to allow the developer to calculate potential profits: Developer profit = Gross development value – costs – price of land

If the price is known it can be used instead of calculating net rents and an assumed interest rate. In a perfect world the calculation of gross development value would be equal to the asset price the purchaser is prepared to pay. In practice they will often differ.

**Table D2: Elements determining land price for private rental development (no planning risk)**

| **Overall equation:** Residual land value = Gross development value – cost of production – developer profit | | |
|---|---|---|
| **Main elements** | **Made up of** | **Subsidiary elements/calculations** |
| Gross development value | Capitalised value of net rental income stream | • Expected rents<br>• Appropriate interest rate |
| Costs of production | Total construction cost | • Number of m2 of new build<br>• Going rate for construction<br>• Cost of dealing with any site-specific problems (slope, contamination, etc.) |
| | Associated land costs | • Local authority requirement for S75 contribution<br>• Rights of light, etc. |
| | Costs of first letting | • Expense of marketing, fit-out<br>• Time required to achieve full occupancy |
| | Fees | • Architects<br>• Surveyors<br>• Lawyers |
| **Developer profit** | Required profit | |

## Complexities: risk

The preceding calculations are simplifications because they do not take account of risk and uncertainty. Adding these elements does not change the fundamental principles but makes the models more realistic and more subject to variation in values. Decision makers will all take these elements into account when making their choices although rarely in a fully transparent fashion. At its simplest they wrap up all the risks they perceive in the yield requirement, which is in principle based on returns on comparably risky investments.

Discussions of the barriers to investment in rented housing often focus on the question of risk. But this risk is not monolithic; there are a number of discrete risks, which appear at different points of the development process. The types of risk to which investors are exposed (as well as the potential returns) depend particularly on the timing of the investment and the terms of their agreement with the developer, and also on their investment model—as some will only buy completed and let units. Table 3 sets out a timeline of risks during the development and transfer process, and indicates how the basic investor/developer models could be modified to deal with these risks.

**Table D3: Risk timeline for PRS development**

| Blanket terms | Stages in development process | Associated risk | How calculations could reflect |
|---|---|---|---|
| Planning risk | Purchase site | Site may have unforeseen problems (contamination, archaeological remains) | Add X% (say 15-20%) for land and planning risk to required returns to developers |
| | Secure planning permission | Planning permission may not be granted for requested scheme. Modifications may be required with associated costs or improved revenues. S75requirements may be different than anticipated. Time taken to secure permission may be longer than expected. | |
| Development risk | Build | Construction costs may be higher than expected. Delay. | Possibly add 5% for construction risk although sometimes just accepted |
| | Initial letting | Units may take longer to let than anticipated<br>Rents may need to be cut<br>Marketing costs may rise | Little experience on which to base estimate |
| Operating or management risk | Operation after full letting | Void risk. Non-payment of rent and consequent costs of eviction. Costs rise faster than rents. | Add x% for operational risk to investor model OR require rent guarantee from AA counterparty |

The main types of risk are discussed below, in the order in which they appear in the development process.

**Planning risk**

The developer calculations summarised in Table D2 assume that planning permission is guaranteed—they do not incorporate planning risk. But a developer buying land without planning permission must explicitly factor this in. First, the developer needs to account for the costs involved in securing planning permission—both in terms of expert advice but also time and the capital that is tied up. More importantly, the developer's required profit will be adjusted up to reflect the risk that planning permission will not be secured for the desired development (or will not be secured at all). A developer who would look for a 20% profit on cost on a development without planning risk might seek twice as much—say 40% profit on cost—on a site where planning permission was required, even though the risk is borne for a relatively short time and there may be means of mitigating it. Additional costs include expert fees and delays as well as variations on numbers of units, costs per unit, planning obligations and other factors. It should however be remembered that there are sometimes opportunities of super profit if permission is more generous than expected or a phased approach allows a better understanding of possibilities.

**Development risk**

Development risk includes construction risk, which is associated with changes to the specification, delays and other unexpected issues such as access to the site and contamination (or even finding protected species). Interviewees regarded these as well understood. They probably account for some 5% of estimated costs or are sometimes simply accepted. Developers normally do site surveys to assess 'abnormal costs', which can be passed onto the landowner.

We have also included initial lettings risk in this category although there is always the possibility of transfer at completion with the investor taking on the first letting risk. Institutional investors would normally not take this risk directly. This risk includes whether the tenants are those expected; whether there is a good pipeline of potential tenants; how the social housing element is filled; how much the marketing costs; and how much initial lettings impact on longer term costs and revenues. This initial letting risk was highlighted in a number of interviews, in part because there is relatively little experience to go on.

**Management or operating risk**

This is the main long-term income risk for owners and investors, and affects the difference between the gross rent and the net rent. The level of risk depends on how rents develop (whether they increase in line with incomes; the impact of any changes to rent control and housing benefit, etc.); the form of contact between the investor and the property manager; the quality of the building; the tenants' treatment of the property; and the manager's efficiency and skill. To some extent these risks can be reduced if the initial specification is correct, especially if the eventual manager was involved at an early stage.

**More general risks**

Table D4 covers more general risks, which do not usually enter formally into developer or investor calculations even though investors in particular raised concerns because of their longer term involvement. It also gives some assessment of the degree to which important market actors are willing to bear these risks.

Exit risks are to do with whether the exit strategy can actually be carried out at the expected price. So for instance for a buy-to-let investor, exit risk depends on how capital values and tax requirements are expected to develop, and over what time period. For longer-term investors the risks are more about whether there will be a market among investors (which is obviously very thin at the moment) and the costs of transfer into owner-occupation if this proves to be the best available option at some stage. A number of models incorporate onwards sale for £1 at the end of the investment period; the return is taken up front.

Reputational risk is mainly about what happens if a tenancy goes wrong; whether management is effective; or there is bad publicity around the PRS more generally. Most institutional investors want an income stream like bonds provide, with none of the hassle of dealing with tenants or managers, but in the past private renting has been seen as a difficult residual sector with many associated problems. The aim of most investors is to separate the high quality investment units from the more general product, and for this reason some investors would support well organised regulation as long as it did not affect rental streams. Some are concerned about their good name across their whole portfolio so put a very high 'price' on these risks.

*Regulatory and policy risks:* traditionally the concern has been around the potential re-introduction of rent controls and increased security of tenure. Although the current Scottish Government have made clear their interest in supporting investment in the PRS this continues to be seen by some stakeholders a significant risk. Moreover, historically there have been sudden changes of policy (often after elections), so many market actors are risk averse. The more general problem of policy risk lies around the possibility of unexpected initiatives; of crowding out—e.g. via Help to Buy—or tax changes that affect returns and sales.

**Table D4: More general risks**

| | Exit risk | Reputational risk | Regulatory/policy risk |
|---|---|---|---|
| Long-term institutional investors generally willing to bear? | Need clear strategy to mitigate | Remains a big concern | Want certainty |
| Non-institutional professional investors willing to bear? | Need capacity to sell at will | Remains a concern | Want certainty |
| Developers willing to bear? | Some want to be able to trade | Not bothered | Unworried if able to exit through sale |
| Housing associations willing to bear? | Some | Yes--believe they can mitigate | Have no choice |

In general long-term institutional investors seek low-risk, relatively certain investments, and in exchange are willing to forego potential high returns. They show little enthusiasm for funding developments that do not have planning permission, and look for a stable policy environment and a known exit strategy.

**Complexities: Finance**

The simplified investor and developer calculations presented earlier in this section do not take account of the realities of financing. In practice, developments are typically funded several times, as more expensive sources of funding (which are the only ones available at high-risk stages of the project) are replaced by cheaper funding when risks diminish. Table D5 sets out funding stages for our notional speculative PRS-only development. The first stage, which involves the most risk, will only be financed by funders willing to accept high risk in return for the potential of high returns; these may include private equity firms that accept they may lose significant amounts but in exchange take a high proportion of uplift. In the past banks would have been a source of funds at this stage but are currently very wary.

Once planning permission is secured planning risk (which covers a range of costs not just whether planning permission will be granted so simply buying subject to planning permission does not fully address) no longer an issue, the developer can refinance out the original deal to get cheaper finance. Banks are willing to lend at this stage, but will generally only cover about 50% of the cost of development and are often looking for pre-sales. The rest comes from the developer's internal sources or more expensive external debt finance. Some institutions will contract to the final income at this stage, which unlocks cheaper finance.

**Table D5: Financing timeline for development : traditional pattern**

| Stages in development process | Average length of stage | Sources of finance | Cost of funds |
|---|---|---|---|
| Purchase site;<br>Secure planning | 12-24 months; occasionally much longer | Private equity<br>Short-term bank loan<br>Developer's equity | High because of planning risk.<br>Private equity may take a large proportion of planning gain |
| Build<br>Initial letting | 12-18 months | Developer equity<br>Bank loan | Say 5% on 50% of cost, once development risk addressed |
| Operation after full letting | Long term | Institutional investors<br>Bonds<br>(Banks have generally withdrawn from this market) | For de-risked investment (with guarantee or leased by AA counterparty) institutions require income yield of say 4-5% |

### Conclusion

The main objective of this section is to clarify that simple investment rules – like a required yield of X% – actually hide the far more detailed assessment of revenues, costs, financing and particularly risk that developers and investors undertake.

Absolutely central to the capacity to estimate risk-adjusted returns is an evidence base in relation to each of the elements described above. In practice there are many rules of thumb used by developers and institutions alike and someone (or some committee) has to take a view of the overall risk/return balance. Financial calculations help that process, but can only provide evidence of potential returns as a baseline for these more general decisions—and like all mathematical expressions are only as good as the data they are based on.

Perhaps the most important implication is that early investors will probably be those who have individual reasons for taking on a new activity in the residential context. This almost inherently implies that they see some potential for super-profits. Later entrants will have the evidence of past experience of success and failure so that investment becomes a less risky and more mainstream decision.

## Annex E: Examples of existing financial models to channel investment into rented housing

Examples of direct purchase models

### Resolution Foundation

The Resolution Foundation is a London-based think tank that specialises in research into the problems affecting middle-income families in the UK. In October 2013 it published the description of a rental-housing investment scheme that would channel institutional funds into a number of housing developments across the UK. These developments, all in the planning or construction stage, are owned by housing associations. Institutions would purchase a majority share in a portfolio of units from the associations, which would retain a small equity stake. The institutions would receive a rental income stream from the investments and contract with the housing associations to manage them.

The Resolution Foundation's calculations suggest that depending on the exact portfolios chosen, investors could expect an income yield of between 3.9% and 4.7%, and IRRs including capital growth of 6.5-7.2%. Returns would be higher if the investment were concentrated in high-demand areas rather than spatially spread.

As set out the model does not lead to any new housing provision, as it is based on actual sites that already have planning permission. Rather it is intended a demonstration exercise to show that this type of investment could work in principle.

### Halcyon

Halcyon City Living is a recently formed company that is hoping to develop market-rent housing in Scotland. It focuses on larger development sites in prime or good locations in major cities. The intention is to sell the housing to investors when it is fully let and income is stabilised. The firm reports that major investors are interested, but will require a government guarantee of the rental stream or shortfall, at least initially until the concept is proven.

### Bond models

### Carduus

Carduus is a Scottish bond aggregator, formed in 2012 to provide low-cost, long-term finance to RSLs. Its first bond will be launched in late 2013/early 2014 (no firm date announced), allowing participating Scottish housing associations to access funding at historically low rates. Each association can commit to any level of borrowing from £1m upwards. The funding must be drawn down immediately and will be repaid in amortized payments over 30 years. About 15 housing associations have pre-qualified, though it is not yet known precisely how many will participate in the first bond issue. The only other aggregator currently operating in this market is The Housing Finance Corporation.

Participating associations can use the funding for any purpose, including new construction for social, mid-market or private rent, or refurbishment. Not all the funds will be available for these uses, though, as a significant proportion will go to refinancing the associations' existing obligations to banks—many of which are trying to re-price their loans to housing associations and even withdraw from this market. Carduus takes a charge on some of the borrower's unencumbered property, so the loan is secured on the financial performance of that stock. These assets are valued on a discounted cash flow basis in existing use.

Carduus expects the bond to be placed with a small number of institutional investors; it is ideal for annuity funds as it matches the profile of their outgoings. HSBC will manage bids from a suite of interested investors.

### Lease models

### Bellerophon

Bellerophon, founded about two years ago, is a limited partnership headquartered in Cardiff and with offices in Scotland. It works with a major annuity provider to fund affordable and market rented units. They act as both broker and aggregator, channelling investment from the institution to fund construction of new housing. This housing is owned by a joint-venture LLP and leased to the local authority for a fixed period with a purchase option for the local authority or RSL.

The organisation is a private firm but has partly charitable goals. They aim to build affordable housing that rents at 65-100% of LHA. The organisation that operates the housing stock (usually a local authority) agrees to lease it and manage it; this is a straight lease, not a rent guarantee. The local authority in turn may allow housing associations to operate the units. Bellerophon aggregates the developments to achieve transaction sizes that will match institutional needs (£10 million and up).

The investment value of these schemes is generally not much more than the build cost, so there is little immediate profit; Bellerophon typically defers its profit for 10 to 20 years, then exits. Bellerophon say the scheme requires little or no grant due to the combination of deferred profit, competitive build prices and low long-term finance charges. Because the scheme is based on the participation of local authorities it will usually require a local authority or RSL participant to go through European Union procurement procedures.

In Wales Bellerophon won a £1 billion procurement challenge hosted by the Welsh public sector, RSLs and local authorities, and their first scheme will start in January with about 200 units.

### M&G

M&G, part of the Prudential Group, is one of the pioneers of institutional investment in rented housing. One of the two schemes it has invested in so far is located in London at Aberfeldy New Village at East India Dock. M&G bought the land from a housing association, and has contracted with a large developer to provide both affordable and market rent units. M&G will fund the construction, and when it is completed the housing association will take a 30-year lease on the whole scheme (both affordable and market housing) from M&G. Lease payments for the affordable/social and market units are calculated separately, and the association has the option to purchase the affordable and social units for £1 after 30 years.

M&G is paying the developer in agreed stages, with a large final payment. This provides collateralisation—if the developer fails it will allow M&G to get someone else to finish the project—which reduces development risk. M&G did not commit to funding until after planning permission was secured.

The investor (underlying investors are generally UK pension funds) gets cash flow (usually inflation linked) and a potential capital upside with their exposure to London residential.

The housing association gets access to additional stock without taking development risk for new build (or can release a large chunk of capital tied up in the PRS for existing developments, which they can use to invest in their core mission) through the £1 end-of-lease purchase option for the affordable housing. They maintain control of the entire development and the size gives them significant economies of scale, which allows them to push down the gross-to-net difference and enhance the profit rent component between net income and the underlying lease payment to the investor. The association takes on management risk, voids and the risk of bad tenants.

The viability of this approach depends on having a strong credit-rated counterparty who can take on that risk—either a local authority or an RSL. The developer gets access to a complete financing and pre-committed sale solution at competitive pricing, subject to final planning approvals and a lease pre-commitment from the RSL or local authority.

## Models that harness borrowing capacity of local authorities

### Resonance

This scheme was developed by Rettie & Co., a Scottish estate agent and property advisor. It seeks to use mid-term (+/-10 year) funding at quantitative-easing rates of interest to stimulate the construction and subsequent rental or sale of the finished properties at affordable rates. By borrowing at government (PWLB) rates or by private funders, low-interest funds are secured to provide what is in effect a 10-year interest-only mortgage secured on the finished value of a residential construction project. This 'mortgage', or refinancing, is limited by the capacity of the net rents to service the interest rate charged and by a prudent loan-to-value ratio. The lower the interest rate charged, the lower the rents that can be safely sustained (reducing void rates) or the higher the quality/cost of construction. The assumption is that the principal of the loan will be repaid out of sales over a 10-year period.

The refinancing is intended to cover the construction costs and contractors' margin on a project. The intention is that the underlying land value is treated as an equity investment which remains at risk until the refinancing is repaid. The refinancing is agreed before construction starts, and as a result banks will offer a short-term construction loans, allowing contractors to tender or SME developers to get building. Only the refinancing debt is guaranteed; there is no guarantee of return to the equity or of rental income. Equity is still reliant on successful rent profiles and eventual sales receipts for its return – i.e. it is taking a full market risk, whether on occupancy demand (rents) or sale demand.

A key characteristic of the Resonance model is that the units covered by any S75 agreement (usually 25% of the total) are also built, but are not sold and remain rented at affordable rents in perpetuity. The title to these units is transferred to the public sector, together with the pro-rata refinancing obligation on them. Equity therefore has to achieve its return from sales of the 75% of units not covered by the S75. In effect, the embedded equity value of the S75 units (the difference between their open-market sales value and the value of the refinancing obligation) passes to the affordable sector in exchange for access to inexpensive 10-year funding. The arrangement of a loan is not the purchase of goods or services, and as such should not be subject to EU procurement regulations.

The model could offer attractive returns for institutional investors. We were told that the net net IRR profiles on deals done to date were between 9% and 14%, and investors can take either the equity exposure over a 10-year period, purchase the debt (in effect a gilt) or acquire a blend of both.

**National Housing Trust initiative (NHT)**

The Scottish Government, with support from the Scottish Futures Trust (SFT), developed the original NHT model for councils and developers. This model leverages in private sector funding and council borrowing to support the delivery of homes for intermediate (mid-market) rent. Developers build the homes to agreed standards and timescales. Limited Liability Partnerships (LLPs) composed of the council, the developer and SFT are set up to oversee progress on each developer's site within a council area.

Once complete, the homes are purchased by the relevant LLP. The LLP pays between 65% and 70% of an agreed purchase price to the developer upfront. This contribution is funded by participating councils, who provide loans to the LLPs in their area; the Scottish Government provides participating councils with a guarantee that it will cover capital and interest payments if the LLP is unable to pay the council. The remaining 30% to 35% of the purchase price is contributed by the developer as a mixture of loan funding and equity investment.

Homes are expected to be available to tenants for five to ten years. The developer can trigger the sale of the homes between years six and ten, with tenants given the first option to buy. Sales proceeds are used first to repay the council's loan to the LLP, and then to reimburse any calls on the Scottish Government guarantee, before the developer receives repayment of loan funding and any repayment of equity capital (up to a capped level). To date, 10 councils have secured deals with 13 developers to deliver over 1,000 homes through this model at various locations across the country.

The 'NHT council variant' supplements the original model. It follows the same basic principles but places the council at the heart of a partnership set up to own, manage and maintain the homes. Members of the partnership (in the form of an LLP) include SFT and the council.

The NHT council variant has only one LLP per council area, and is supported by a capped Scottish Government revenue-only guarantee to councils. Councils can propose either new-build or existing homes for LLP acquisition. Any homes purchased must be available for rent for between five and ten years; after that the council is free to use the dwellings or sell them as it wishes. To date 175 homes have been approved through this route, with more in the pipeline.

The NHT initiative includes a version designed specifically for Registered Social Landlords (RSLs). This was launched in 2012 and bids were received to deliver several hundred homes across Scotland. The total cost of the homes in this variant is made up of two parts: (a) RSL debt that the net free rental income repays and (b) equity invested by an RSL (which could come from land or other resources).The Scottish Government offers an NHT guarantee to RSLs to support the debt finance raised for a maximum period of 10 years, building upon the principles of the original model. No partnership vehicle is needed. Homes can be new build or created through the conversion of non-residential property, and can be developed directly by RSLs or procured from private developers.

Homes must be affordable to households on low to moderate incomes, and must be made available for let to target tenant groups at an intermediate (mid-market) rent for a minimum of five years. If an RSL wishes, it can begin to sell the homes after the initial five-year letting period. There is flexibility on exit to enable RSLs to retain homes indefinitely.

**References**

Alakeson, V., Blacklock, K., Halilovic, S., Rothbury, T. and Salisbury, N. (2013) *Building Homes for Generation Rent* London: Resolution Foundation

Alakeson, V. (2013) *The challenges of build to rent for UK housing providers London:* Resolution Foundation

Alakeson, V. (2012) *Making Institutional investment in the private rented sector work London:* Resolution Foundation

Building and Social Housing Foundation (2012) 'Building New Homes for Rent' Coalville: BSHF

Cadman, D. and Austin-Crowe, L. (1991) *Property Development London*: E&FN Spon

Communities and Local Government Committee (2013) *The private rented sector* (HC 2013-14, 50)

Communities and Local Government Committee (2012) Financing of new housing supply (HC 2010-12, 1652)

COSLA (2011) 'National Housing Trust—Councils' Experiences' www.cosla.gov.uk/system/files/private/cw110526item08.pdf

Crook, T., Ferrari, E. and Kemp, P. (2012) 'Knowing the Area: The Management of Market and Business Risks by Private Landlords in Scotland' *Urban Studies* November 2012 vol. 49 no. 15 3347-3363

Crook, T. and Kemp, P. (2012) Written submission to Communities and Local Government Committee *Financing of new housing supply* (HC 2010-12, 1652, Volume II)

Crook, T. and Kemp, P. (2011) *Transforming Private Landlords Oxford*: Wiley Blackwell

Englander, D. (1981) *Landlord and Tenant in Urban Britain 1838-1918 Oxford:* Oxford University Press

Halifax (2013) *Generation Rent: A Society Divided? Perceptions of the First-Time Buyers Market*, Halifax, Edinburgh, Lloyds Banking Group http://www.lloydsbankinggroup.com/media/pdfs/halifax/2013/1706_Halifax_Generation_Report.pdf

Hamnett, C. and Randolph, B. (1988) *Cities, Housing and profits: Flat break –up and the decline of private renting* London: Hutchinson

Hill, W. (2006) 'Chapter 4: Attracting institutional capital' in Bill, P. (ed) Mo*re homes for rent: Stimulating supply to match growing demand,* London: The Smith Institute

Homes and Communities *Agency (2013) Protecting social housing assets in a more diverse sector: A discussion paper on the principles for amending the regulatory framework for social housing in England* London: HCA

http://www.homesandcommunities.co.uk/sites/default/files/our-work/130404_regulatory_framework_discussion.pdf

Hughes, J. (1995) 'The impact of the Business Expansion Scheme on the supply of privately-rented housing' *Journal of Property Finance,* Vol. 6: 2, pp.20 - 32

HM Treasury (2010) *Investment in the UK private rented sector*

Milligan, V., Yates, J., Wiesel, I. and Pawson, H. with Hamilton C. (2013) *Financing rental housing through institutional investment Volume 1: Outcomes from an investigative panel* Melbourne: AHURI

Montague, A. (2012) *Review of the barriers to institutional investment in private rented homes (The Montague report)* London: Department for Communities and Local Government

Murja Ltd (2012) *Report on Long-term Funding Options* Glasgow: Scottish Federation of Housing Associations

Oxley, M., Lishman, R., Brown, T., Haffner, M. and Hoekstra, J. (2010) *Promoting investment in private rented housing supply: International policy comparisons* London: DCLG

Paragon (2013) 'UK private rented sector and buy-to-let market 2013' Wolverhampton: Paragon Group of Companies
http://www.paragon-group.co.uk/Files/MAIN/pdf/PRS%20Reports/PRS%20paper%202013.pdf

Scanlon, K. and Kochan, B. (eds) (2011) T*owards a sustainable private rented sector: The lessons from other countries* London: LSE London

Scottish Futures Trust website
www.scottishfuturestrust.org.uk

Scottish Government (2010) *Planning Advice Note 2/2010: Affordable Housing and Housing Land Audits* Edinburgh: Scottish Government

Scottish Government (2013) *A place to stay, a place to call home: A strategy for the private rented sector in Scotland* Edinburgh: Scottish Government

Whitehead, C. and Kleinman, M. (1986) *Private Rented Housing in the 1980s and 1990s* Occasional Paper 17, Cambridge: Department of Land Economy, University of Cambridge

*improving living in scotland*

HOMES FOR SCOTLAND

Building the Rented Sector in Scotland

Homes for Scotland, 5 New Mart Place, Edinburgh EH14 1RW
Tel: 0131 455 8350 Fax: 0131 455 8360 Email: info@homesforscotland.com
Web: www.homesforscotland.com Twitter: @H_F_S