CLIFFORD CHANCE

Briefing note

March 2017

Build to Rent – opportunities and challenges

The private rented sector (PRS) in the UK has doubled over the last decade. As the lack of housing supply continues to drive up house prices across Britain, 'build to rent' (BTR), a sub-sector of PRS, is attracting new investors seeking to capitalise on the growing demand for high-quality rental properties.

In the year to Autumn 2016, the number of BTR units that were completed, under construction or with planning permission increased by more than 200%, demonstrating the BTR sector's rise in popularity in recent times. With the government having reaffirmed its commitment to BTR in its Housing White Paper, released on 7 February 2017, the future looks bright for the BTR market.

What is 'build to rent'?

Traditionally, the majority of rented homes in the UK have entered the PRS when 'units for sale' developments could not be sold or when existing owner-occupied homes were converted into buy to let properties.

BTR developments, on the other hand, consist of properties designed and built specifically for renting. These are high-quality, professionally managed properties, often offering onsite amenities (such as a concierge, communal roof terraces and gyms) and good transport links, with a focus on the tenant.

According to the British Property Federation (BPF), there are currently 80,322 BTR units completed, under construction, or with planning permission in the UK and 38,079 of these units are in London with the remainder being located elsewhere.

Opportunities

Stable income

Despite the perception that BTR developments produce smaller returns than developments for sale, the combination of rising house prices and rising rents is attracting large investors into the sector.

Investors, including M&G, Legal & General, LaSalle, Grainger, APG, Aberdeen Asset Management, EDI Group, Westrock, Criterion Capital and Quintain seek not only to benefit from stable, long-term returns generated by high rents, but also from the steady increase in the value of their assets over time.

The long term nature of the investment makes BTR particularly attractive for pension funds and sovereign wealth funds, who typically commit investment for at least a decade. Several local authority pension schemes are also investing in BTR

Key issues

- BTR developments are designed and built specifically for renting
- Attractive to investors seeking long-term, steady rental yields as well as new sources of income
- Generally can be more difficult to launch than build for sale developments
- Potentially high operational costs
- Failure to address tax upfront can negatively affect returns
- Piecemeal regulation regime which could be expanded
- Registered Providers play a key role in many PRS schemes
- BTR could deliver a total of 240,000 homes in England and be worth £60 billion by 2030

as a way of delivering affordable rented homes for key workers that are critical to their local economies. Indeed, the recent Housing White Paper suggests that the pooling of local government pension funds will increase opportunities for local government assets to be used in support of infrastructure projects, including housing.

Strong demand

Many institutions believe that a shift to renting among younger city-dwellers will prove to be a structural, long-term change. The BTR model can cater to this shift with its ability to accelerate housebuilding three-fold on large urban sites that are well connected to employment markets. Further, the purpose-built nature of BTR developments provides future tenants with enhanced facilities that do not accompany traditional homes. As conventional house builders fall short of providing the 225,000 to 275,000 new homes per year required to track population growth and address years of under-supply, demand for high quality PRS schemes will continue to rise. Demand for PRS is also underpinned by affordability constraints in many parts of the sales market and increased hurdles in the mortgage market, as well as higher taxes and cuts to mortgage interest relief imposed on buy to let landlords. Testament to the increasing demand is PwC's estimation that 25% of households will live in the PRS by 2025, a rise of 6% since 2014/2015.

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Diversification

Due to the relatively low volatility and counter-cyclical nature of BTR developments, institutional investors are increasingly looking to large-scale BTR projects to diversify their portfolios. A recent survey of institutional investors by Knight Frank suggested that they would invest £50 billion in the BTR sector by 2020.

Government initiatives

The Build to Rent Fund, originally announced in the Autumn Statement of 2012 as a £200 million fund and then increased to £1 billion in 2013, involved the government sharing risk or bridging finance to help new schemes to be built, managed and let. Developers then sold on their interest or refinanced and repaid the government investment once a scheme was fully let.

The Build to Rent Fund thereafter became part of the broader Home Building Fund, launched on 3 October 2016 and comprising £2 billion of long-term loans for infrastructure (estimated to unlock up to 200,000 homes) and £1 billion of short-term loans targeted at SMEs, custom-builders and innovators (for the delivery of up to 25,000 homes by 2020).

The £3.5 billion Private Rented Sector Guarantee Scheme, launched in 2013, provides landlords of new rented homes with government guarantees, allowing them to secure long-term financing. To this end, a bond for £265 million has been issued, of which £175 million was funded immediately and the rest retained while applications are processed. The application process closes at the end of 2017 and there is potential for the scheme to be expanded by up to £3 billion.

Most recently, the Housing White Paper announced that the government is consulting (until 1 May 2017) on a range of measures aimed at encouraging major institutional investment in the BTR sector. The proposals include changing the National Planning Policy Framework so that local authorities proactively plan for BTR schemes where there is a need and introducing a definition of 'affordable private rent' (APR). APR is proposed as a particularly suitable form of affordable housing for BTR schemes and could count towards developers' affordable housing requirements in place of the more traditional forms of affordable housing. The proposed features of APR are: 1) the rent must be at least 20% below local market rents; 2) at least 20% of homes in a BTR scheme must be APR; and 3) family-friendly tenancies of 3 years or more should be available to tenants who would like them. Such reforms, if implemented, would provide developers with greater planning certainty.

Challenges

The risks and returns of BTR developments differ significantly from those in conventional build for sale projects. Investors must therefore consider the impact that the unique features of BTR developments will have on their investment strategy. We set out below some examples of these challenges.

Return profile

Where property is built for sale, invested capital is only tied up, subject to market conditions, for a short period of time until the new homes are sold. Where property is built for rent, however, there is no instant return from sale – the investor must be prepared to commit capital for up to 30 years. For this reason, BTR developments will not appeal to all institutional investors. Conversely, the value of a build for sale scheme can be exposed to market downturns, whereas arguably a BTR scheme has more stability and flexibility.

The absence of an instant profit element means that builders for sale are often able to outbid BTR investors for land, making BTR developments often more difficult to launch. The high land prices in London and the South East are particularly challenging and achieving viability in regional cities can prove to be easier.

Operational costs

Given the nature of the investment, effective building management and maintenance are central to protecting the long-term value of a development. The operating expense budget will therefore be key to the viability of any BTR project.

Many existing residential management agents are small, not always qualified to manage large developments and often charge high fees. For this reason, some developers will set up affiliated management companies so as to provide economies of scale and to lower costs by retaining the fees within the same umbrella.

VAT

Residential property developers of build for sale projects are generally able to recover any VAT they incur on development costs (e.g. in relation to professional fees - no VAT should be payable on the construction costs themselves) on the basis that they make 'zero-rated supplies' when they sell or grant long leases (over 21 years) of the newly built dwellings. With careful planning, investors in BTR projects should also be able to recover such development costs, but will not be able to recover VAT incurred for ongoing costs (e.g. management, maintenance and repair) on the basis that the granting of short leases to residential tenants gives rise to 'exempt supplies'. The business plan will need to factor in these additional costs.

SDLT

In the case of BTR, an investor acquiring bare land (or non-bare land which is 'commercial' or 'mixed') for development will pay SDLT under the 'slice' system at non-residential rates up to 5% (as increased under the 2016 Budget).

In the case of buy to let, an investor acquiring residential property could be subject to the 3% surcharge introduced from 1 April 2016 (although 'multiple dwellings relief' may be available to help mitigate SDLT) on top of the standard residential rates of SDLT (currently up to 12% under the 'slice' system). However where the investor acquires six or more dwellings together it should be able to benefit from the lower non-residential rates mentioned above and therefore not be subject to the 3% surcharge.

A buy to let investor acquiring fewer than six dwellings would normally be subject to SDLT at residential rates under the 'slice' system up to 12% and could be subject to the 3% surcharge on top of that (subject to the effect of any 'multiple dwellings relief' claim).

The 3% SDLT surcharge is problematic for many investors. Some investors have commented that the Housing White Paper is an encouraging recognition by the government of the pivotal role institutions can play in addressing the current housing shortage, but that the next step is to remove existing barriers to delivery such as the SDLT surcharge. In October 2016, the BPF encouraged the government to be more targeted in its approach by, for example, introducing a capital gains tax surcharge on second homes which are not rented out to replace the SDLT surcharge on investors.

In certain circumstances, a corporate purchaser of residential property could be liable to a flat 15% SDLT and an ongoing charge under ATED (Annual Tax on Enveloped Dwellings). Applicable exceptions need to be considered and claimed on a case by case basis.

Non-Resident Landlords

Non-resident investors need to register under the UK's Non-Resident Landlords Scheme and apply for gross payment direction(s) from HMRC in order to be eligible to receive UK rents without withholding of UK income tax (currently at a rate of 20%).

Although the UK does now impose a capital gains tax charge on non-resident investors disposing of UK residential property, such non-resident investors should fall outside the scope of such charge provided that they are 'diversely held' institutional investors (such as pension funds, sovereign wealth funds and most financial institutions).

The UK Government is currently consulting on bringing non-UK resident companies who are currently within the charge to UK income tax (e.g. a non-resident landlord's rental income) or within the charge to UK capital gains tax (e.g. gains of certain non-resident companies disposing of UK residential property) within the scope of UK corporation tax. The precise impact of such a move will depend on the outcome of that consultation exercise, but it is anticipated that it would mean that such non-UK resident companies would then be subject to the rules which apply generally for the purposes of Corporation Tax, including the limitation to corporate interest expense deductibility and loss relief rules.

Transactions in Land Rules

The UK Government recently announced a new anti-avoidance regime targeting the indirect trading or developing of UK land. These rules primarily aim to prevent avoidance of UK tax through the use of offshore PropCos the shares in which are then traded, rather than the UK property asset itself. Unfortunately the new legislation enacting these rules is very broadly cast and this gave rise to some concern in the industry that the new rules could inadvertently catch genuine BTR / "develop to hold" investment structures. However, HMRC have repeatedly stressed in their guidance and in industry consultation that the new rules are aimed at trading activities and are not intended to alter the UK tax treatment of or recharacterise genuine investment activity.

Regulation

The PRS is heavily regulated and landlords must comply with a wide range of rules – over 50 Acts of Parliament and 70 sets of regulations according to the National Landlords Association. Regulation already provides local authorities with the power to introduce local licensing schemes for the PRS, and places statutory obligations on landlords to, for example, check tenants' immigration status, follow appropriate electrical, gas and fire safety regulations and meet energy efficiency obligations.

There has been ongoing discussion about regulating the PRS further but there has also been recognition of the need to consolidate the current piecemeal regulatory regime. Ideas for further regulation include introducing licensing programmes in selected areas, a national register of landlords, a national autonomous body with statutory powers to oversee regulation and a common code of practice.

Market Information gap

Given that only a fraction of existing PRS stock has been built specifically for rental despite growing interest in this sector, optimising investor returns by designing a product for different types of tenant, each with different needs, remains a challenge. To date, the only source of market information available has been from the fragmented buy to let market. As a result, there is little industry-wide understanding about what different tenants want from a bespoke private rental product and how those needs relate to the cost of development, cost of management, term of tenancy and rent levels.

The Council for Mortgage Lenders, which represents housing lenders and investors with over £60 billion of private finance in social housing, called for 'a clear and stable long-term framework for investment', suggesting that funders may benefit from further clarity from the government regarding the role of institutional investment in the BTR sector.

Political Risk

Any measures introduced by government such as rent controls and long-term security of tenure would be very likely to drive institutions away from the sector as they did in the 1960s and the 1970s. This was a period when varying statutory protections for tenants were introduced, many of which have been repealed since. A change in government might mean a change in policy direction. It is therefore important that there is a political market–based consensus on the PRS.

The role of Registered Providers

Private registered providers (RPs) or housing associations are private, non-profit making organisations that provide low-cost 'social housing' for people in need of a home. Any trading surplus is used to maintain existing housing and to help finance new homes. Although independent, they are regulated by the state and are eligible to receive some public funding.

With grant funding continuing to decline, the BTR model provides an opportunity for RPs to attract new capital into their businesses, whilst their expertise in property development and management are proving to be key factors in encouraging the sector to develop and move forward. This is particularly the case given that some investors remain wary of taking on the risks of construction themselves. Additionally, BTR developments can help RPs to offset shrinkage in their development programmes, whereas surpluses from these developments can be used to cross-subsidise their social housing activities.

Those RPs which are registered as charities will need to determine whether BTR fits within their charitable purpose. To date, most RPs which have undertaken BTR developments have done so through non-charitable subsidiaries. These include Fizzy Living (a PRS developer owned by Thames Valley Housing (an RP)) and Silver Arrow (an investment entity owned by the Abu Dhabi Investment Authority). However, the lack of charitable status means that SDLT is incurred, which in turn affects returns.

RPs already provide 50,000 homes for market rent and they are reported to be investing many millions over the coming years in the PRS sector to grow their offer and build thousands of new homes for market rent.

Conclusion

With four times as many PRS schemes under construction or in the pipeline at the end of 2016 as were built in the previous seven years, the BTR sector is truly gaining momentum. It is reported that BTR could deliver a total of 240,000 homes in England by 2030, providing a sector comparable in value to that of US Multi-Family REITs (the American equivalent of BTR), which is worth approximately £60 billion. It is therefore not surprising that BTR has now received national policy recognition and that high-net-worth companies are entering the BTR market with the intention of creating an institutional asset class. As research from Strutt & Parker, Stanhope and Network Homes suggests, the UK appears to be on the brink of a large scale, commercially developed, owned and operated BTR sector.

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