

Report of the Directors of City Development and Environment and Housing

Report to Scrutiny Board (Housing and Regeneration)

Date: 25th February 2014

Subject: Recommendation Tracking - Affordable Housing by Private Developers – the role of institutional investors

Are specific electoral Wards affected? If relevant, name(s) of Ward(s):	<input type="checkbox"/> Yes	<input checked="" type="checkbox"/> No
Are there implications for equality and diversity and cohesion and integration?	<input type="checkbox"/> Yes	<input checked="" type="checkbox"/> No
Is the decision eligible for Call-In?	<input type="checkbox"/> Yes	<input checked="" type="checkbox"/> No
Does the report contain confidential or exempt information? If relevant, Access to Information Procedure Rule number: Appendix number:	<input type="checkbox"/> Yes	<input checked="" type="checkbox"/> No

Summary of main issues

1. In May 2012, the Housing and Regeneration Scrutiny Board undertook an inquiry into Affordable Housing by Private Developers. Flowing out of this inquiry was a number of recommendations which included several about institutional investment in housing.
2. This report sets out the response to those recommendations.

Recommendation

3. Scrutiny Board is asked to note the content of this report

1 Background

- 1.1 Following the inquiry into the delivery of Affordable Housing by Private Developers in May 2012, several recommendations were identified which revolve around the potential role of institutional investors in Leeds to increase new affordable housing supply.
- 1.2 The inquiry identified that housing growth could be supported by the expansion of the rented sector and that a good quality private rental offer could both support flexibility in the labour market and provide more choice in the housing market. In the context of still limited growth in the housing market, an expanded rented sector has the potential to meet the needs of people who would not be eligible for social housing but cannot access owner occupation, a segment of the market which is currently not catered for.
- 1.3 It concluded that investment from large institutions, such as large pension funds or insurance companies, could deliver more high quality and professionally managed rented property than smaller 'buy-to-let' investors due to their economies of scale and professional experience.
- 1.4 The recommendations flowing out of this are for a more detailed exploration of institutional investment as a source of new investment in residential properties including affordable homes.
- 1.5 The specific recommendations are set out below:

3 (i) That the Executive Board request the Directors of City Development and Environment and Neighbourhoods as appropriate to undertake further work and review the opportunities and potential for a visionary new housing management role for the Council or external provider to remove the barriers around investment in residential properties and affordable homes in the city.

4 That the Directors of City Development and Environment and Neighbourhoods, as appropriate, work closely with all relevant financial institutions to identify and report back to the appropriate Scrutiny Board on ways to deliver the affordable homes needed in the city.

5 That the Directors of City Development and Environment and Neighbourhoods, as appropriate, work closely with all our partners including financial institutions develop an investor model for large scale institutional investment in the rented sector and report on progress to the relevant Scrutiny Board by the Autumn of 2012

- 1.6 This report provides an update against each of these areas of work.

2 Main Issues

- 2.1 Residential property investment has historically often sought capital growth rather than income. Institutional investors are trying to match investments against liabilities, often pension payments, and hence require a steady and

reliable income stream in addition to capital growth. The interest of institutional investors in residential letting has been growing and is as a result of the institution's requirement for a regular income stream in a market where significant capital growth has largely dwindled.

- 2.2 Recognising this potential new source of funding, the government commissioned the Montague Review in November 2012 to consider the potential for attracting large-scale institutional investment into new homes for private rent and accelerating the rate of delivery. It is anticipated that increasing the scale and pace of investment in the Private Rented Sector (PRS) would be delivered largely through property companies backed by institutional investors. The House of Commons / Communities and Local Government Committee Report into the Private Rented Sector, sets out the position following the introduction of measures to support PRS housing, following the Montague Review and a report is elsewhere on this agenda.
- 2.3 Institutional investment in housing is usually identified with market rent housing let on fixed term Assured Shorthold Tenancies to deliver the income stream sought by the funds. Investment models typically entail a long term lease, say 20 – 40 years, require a very secure rental income stream and an investment opportunity of sufficient size to be worthwhile to the funds. Although models can deliver social or affordable housing it should be noted that sufficient rental income is required to cover the lease costs over its duration and this will need to be considered in the light of rent levels in particular neighbourhoods and market areas. In Leeds this most likely entails mid to high market areas. This is not to say that affordable rented housing (defined by government as being up to 80% market levels) could not be delivered through this route but that it is more likely to form part of a market driven model rather than an entirely affordable scheme.
- 2.4 The provision of PRS housing is particularly location sensitive as the target market is generally deemed to be small, relatively mobile households. Schemes are therefore ideally located near to centres of employment or have good connectivity. Moreover the location of schemes will be critical in ensuring high demand and low turnover.
- 2.5 One of the measures government has put in place to stimulate institutional investment is the introduction of the Build to Rent (BTR) funding regime which is managed by the Homes and Communities Agency and which provides loan or equity funding for market rent housing. This has been one of the routes through which the Council is exploring the relevance and potential of institutional investment to the Leeds market.
- 2.6 Whilst there has been an increasing level of institutional investment in London and the South East, anecdotally it appears that this has so far not been replicated in the north. Funds such as Legal and General have recently announced new schemes with local authorities in Kent and Buckinghamshire and are looking for opportunities with other Councils including Salford. An approach has been made to investors to further explore their investment approach and whether it is something Leeds could engage with.

- 2.7 The House of Commons / CLG report notes that delivery of PRS housing at scale is still relatively new and that an enlarged sector will take some time to reach maturity nationally. This probably true of Leeds which still has a relatively small PRS characterised by small investors.
- 2.8 Leeds has had several approaches from property companies, backed by institutional funds, describing a range of models although with a number of common elements described in more detail at 2.20.
- 2.9 Each of these approaches have identified the requirement for a Council owned site as a component of their investment approach, usually on the basis that the completed scheme reverts to Council ownership on expiry of the lease. The challenge therefore is to identify a site or sites in locations which would be attractive to a rental scheme, meeting the requirements of rent levels and demand. These could be in established residential areas particularly those with good connections to the city centre and other centres of employment. The Brownfield Land Programme of sites are being considered in the context of these approaches including the opportunity to package sites or align an institutionally backed schemes with other sources of investment.
- 2.10 The delivery of affordable housing within these schemes will need to be considered in relation to the rent levels in any locality. If schemes in Brownfield Sites can stack up financially it is likely that market rent levels are relatively affordable, although the Council may choose to provide some subsidy to provide or augment the provision of affordable housing as part of a larger scheme.
- 2.11 The market has thus far failed to bring forward institutionally backed schemes in Leeds and the key barrier appears to be the ability of the funds to identify land with sufficient rent levels and values. The rationale for the Council considering support or providing subsidy for schemes includes the opportunity to accelerate housing growth beyond that currently being delivered by the market, an opportunity to support an expanded high quality rented sector to meet housing requirements not otherwise met and potentially to lever in new resources to deliver affordable housing in mixed tenure schemes.
- 2.12 Recommendation 3(i)
- 2.13 This recommendation proposes further work to review the role of either the Council or an external organisation to provide housing management services to remove barriers to investment.
- 2.14 The management of rental schemes is a key factor as investors require certainty of guaranteed rental income. The potential for the Council to undertake housing management services on behalf of property companies / investors will need to be considered in the light of individual propositions presented by them and a view taken on the ability to guarantee the rental stream and the risks associated with it.
- 2.15 Management issues would include:
- Lease costs over the term

- demand risk and responsibility for lettings,
 - management of arrears,
 - void periods,
 - potentially higher relet costs - properties would need to be brought up to a very high standard of fittings and decoration on the point of relet,
 - management of fixed term AST tenancies
 - potential mix of market and affordable rent properties
- 2.16 Developing high quality properties to a good specification will be key to minimising the risk of low demand or high turnover. Responsibility for repair and maintenance would need to be negotiated with the property company and reflected in the lease payments if responsibility lay with the Council. Similarly issues such as ownership after the expiry of the lease and the condition of properties at that point would need to be considered.
- 2.17 The desirability of the Council managing an essentially private rent model would need to be evaluated including that of managing fixed term Assured Shorthold Tenancies. Ordinarily in the PRS these are 6 month lets although the Council could look to let over a longer period.
- 2.18 Overall the Council would need to be comfortable with taking on the long term risk of a scheme - that its construction quality, location and potential revenue stream would represent a reasonable balance of risk. Of the models brought forward by property companies so far none are dependent on the Council necessarily taking on property management although an adequate managing agent would need to be found. If a scheme is predicated on Council land or the Council has had a significant role in enabling a scheme however it might want to have a direct involvement in the management service to protect its interests. The Council may also chose to use its influence through providing a good quality housing management service as a way of driving up standards in the sector.
- 2.19 Partnerships with other housing providers such as housing associations, several of whom already have private rented stock within their portfolios, may provide an alternative to the operation of potential schemes.
- 2.20 Recommendation 4
- 2.21 This recommendation proposes that the Council works closely with relevant financial institutions to develop an investor model for large scale investment.
- 2.22 The Council has had a number of property development organisations approach it and there are commonalties across the models which have been brought forward:
- a long term lease for a period of 20-40 years usually covering the pay-back period;
 - the contribution of Council owned land potentially yielding a capital receipt although this would be reflected in the lease costs;
 - a management arrangement whereby the property is maintained by the organisation undertaking the development for the lifetime of the lease and reflected in the lease payment

- the option for the property to be managed via a managing agent
- in several models the land would revert back to the council at the end of the lease period

- 2.23 The organisations that have approached the Council have advised that there are Institutions interested in investing in these types of projects. The Institutions normally require a partner to undertake the development/construction and put together the structure of the arrangement with the Institution providing the funding for the project linked to receiving a financial return. The Institutions will seek a minimum guaranteed rate of return over the lifetime of the project normally indexed linked to provide the financial return and certainty they require for pension or institutional returns.
- 2.24 These organisations indicate that they require a minimum size of portfolio in which to invest which are usually in excess of 100 units though more often they are seeking more substantial opportunities. The key issue is whether sites are available in areas which would produce a sufficiently high rent level and in locations such that the schemes would be popular and easy to let to minimise revenue risk.
- 2.25 The Council is in the process of approaching institutions to establish whether any will transact directly with the Council or whether they need a developer/contracting party to undertake the lead role. If there is sufficient interest the Council will undertake a more detailed dialogue to establish the level of interest and type of financial models that the Institutions would be prepared enter into to progress the delivery of scheme in Leeds. A variety of Council owned sites could be used to establish the level of interest and financial viability of their propositions.
- 2.26 Given the probable need to locate schemes in mid-market areas, the Council may choose to support or subsidise projects to secure the delivery of affordable rented units or additional units and could look to deliver mixed tenure schemes aligned with the wider affordable housing programmes.
- 2.27 The financial attractiveness of these type of transactions can be compared to the Council using its own funding/prudential borrowing to fund such arrangements to ascertain whether it would be a value for money solution or provide sufficient additionality.
- 2.28 Recommendation 5
- 2.29 This recommendation suggests that the Council works partners and with financial institutions to develop a model for large scale institutional investment in the rented sector.
- 2.30 This has been progressed through participating in the development of a bid to the HCA's Build To Rent fund which has been developed in partnership with Bradford Council and with the support of the Leeds City Region.
- 2.31 Build to Rent has been designed to allow pilot schemes to be identified to test the viability of PRS development through the institutions. It provides

development finance of up to 50% construction costs in the form of loan or equity finance.

- 2.32 This has provided the opportunity to explore a model for Leeds in the context of potential government support and has included the development, via consultants Price Waterhouse Coopers, of a model to test the viability of investment by the financial institutions in large scale private rented housing for specific sites. It incorporated a view from PWC on the likely return expected by the investors and tested the model against market rent levels in Leeds.
- 2.33 The Council has worked jointly with Bradford to submit an Expression of Interest and a site identified as a pilot. A formal procurement exercise would follow if the HCA indicates its initial support and the outcome of the Expression of Interest is due in July.
- 2.34 The development of the model and the ability to access PWC's market knowledge has enhanced the Council's understanding of this as a viable route for investment. The bid will test the appetite of the institutions to invest in Leeds and demonstrate whether rent levels are sufficient to meet the required return on investment.
- 2.35 In addition there are a further three commercial bids to the BTR programme for market rent schemes in Leeds and the outcome of these Expressions of Interest will also be known in July.

3 Corporate Considerations

3.1 Consultation and Engagement

- 3.1.1 Consultation with the Executive Member for Development and the Economy and the Executive Member for Neighbourhoods, Planning and Support Services has been on-going.
- 3.1.2 Site specific consultation will take place with the relevant Ward Members as schemes are identified.

3.2 Equality and Diversity / Cohesion and Integration

- 3.2.3 There are no specific equality and diversity considerations associated with this report.

3.3 Council policies and City Priorities

- 3.3.4 Working with Institutional investors may provide an opportunity to support the one of the priorities set out within the Best Council Plan by providing housing as the city grows.

3.4 Resources and value for money

- 3.4.1 There are no direct resource implications identified at this stage.

3.5 Legal Implications, Access to Information and Call In

3.5.1 This report does not contain any exempt or confidential information.

3.5.2 This report is not eligible for call in.

3.6 Risk Management

3.5.1 Risk management would take on a project by project basis.

4 Conclusion and Recommendation

4.1 The expansion of the rental housing market could be a significant driver for housing growth and institutional investment may provide an important opportunity to accelerating growth and potentially provide affordable housing. A number of activities are underway to further explore this potential including a bid to the Build to Rent fund to test the appetite of the institutions to invest.

4.2 Scrutiny Board is asked to note the content of this report

5 Background documents¹

5.1 none

¹The background documents listed in this section are available to download from the Council's website, unless they contain confidential or exempt information. The list of background documents does not include published works.