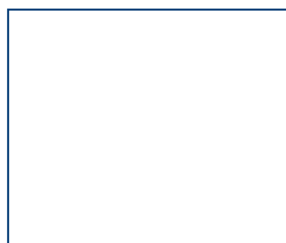
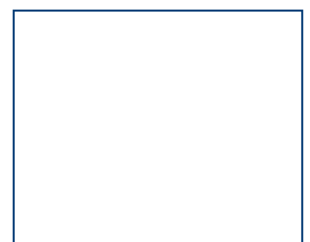
HM Treasury
Investment in the UK
Private Rented Sector

A response from
Mill Group Ltd



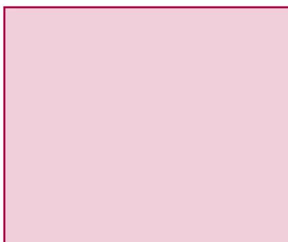


Mill Group's Private Sector Co-Investment model:

"This (co-investment) has the potential to be a more significant development in private housing finance than the buy-to-let mortgage.
The number of mortgaged owner occupiers has been shrinking since the turn of the 21st century because of high costs of housing market entry - which has worsened since the credit crunch. People who neither qualify for social housing nor are able to raise the equity for a deposit are the fastest growing housing segment in the UK."

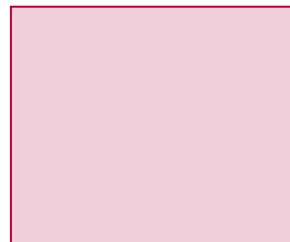
Yolande Barnes, head of Savills Research, November 2009

Winner of ' Most Innovative Funder' for IIC Fund II

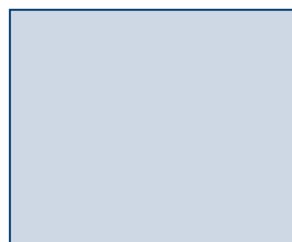


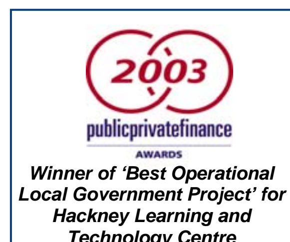
Winner of the Prime Minister's Better Public Building Award

Winner of 'Operational Project with the Best Design' Jubilee Street development,

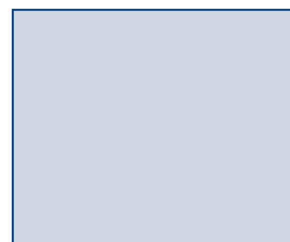


Winner of 'Best non-major health scheme in operation' for Chichester Mental Health PFI project





Winner of 'Best Operational Local Government Project' for Hackney Learning and Technology Centre



MILL GROUP

Contents

Executive Summary	4
About Mill Group	5
Mill Group Private Rented Sector Co-Investment model	6
Socially Responsible Investment	8
Need for Public Sector Leadership	9
Response to the consultation	10

Appendices

Appendix 1 – Investors in Housing Fund 18

Mill Group

Investment in the UK private rented sector

A response by Mill Group

Executive Summary

In submitting our response we would like to highlight the following points:

- Mill Group has a substantive track record in delivering innovation by bringing major UK institutional investors into a new asset class.

- Existing models for UK housing investment have failed (and continue to fail) to be attractive to institutional investors.

- We are sceptical that the current proposed models, as with other historic models, will not generate a substantive PRS in the next 5 years.

- Whilst individual investors have supported the Buy-to-Let market over the past five years, there are many inherent problems with the model, which have significantly restricted the inflow of funding post downturn.

- Mill Group's Co-investment Model is a solution for investors (by overcoming the significant investment barriers) and a solution for aspiring home-owners (by providing a bridge between renting and buying).

- Unlike some other PRS models, no major changes are required in taxation and law.

- However, as with all new models, Government support is welcome for Co-investment to successfully enter the market.

MILL GROUP

About Mill Group

Mill Group has developed excellent long term relationships with institutional investors by offering innovative and socially responsible investment opportunities. Our institutional funds are uniquely supported by public sector pension funds, including the London Pensions Fund Authority and major private sector institutions such as Aviva/Norwich Union, Clerical Medical, and Sumitomo Mitsui. By working closely in partnership with these and other leading institutions, we have been able to identify and develop innovative opportunities to deliver the investment goals of our Investors, as well as efficiently manage their assets.

Formed in 1994, Mill Group has grown steadily and continues to promote new investment funds in property and infrastructure, which mainly comprise housing, schools, health, street lighting and other community PFI investments throughout the UK.

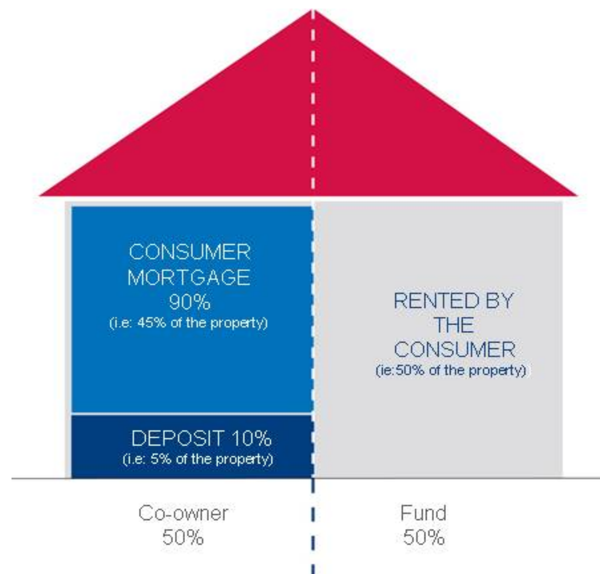
We firmly believe in offering our investors innovative and socially responsible investment opportunities, with clear and balanced information. We remain at the forefront of investment thinking, constantly seeking to create and provide the best property and infrastructure investment funds for our clients.

To this end, Mill Group has recently developed a new Private Rented Sector Co-Investment model through which to acquire residential property, generating attractive levels of income on a very cost efficient basis. This new Co-Investment model has considerable benefits over the traditional “buy-to-let” or AST models.

Mill Group is also currently developing an innovative UK residential investment fund called Investors in Housing Fund, which will be managed through its new residential property arm. (for further details please see Appendix 1)

Mill Group Private Rented Sector Co-Investment model

In essence Mill Group's Co-Investment model is a private sector part rent, part-own model, which provides FTB's with access to the unsubsidised housing market by purchasing a property with an institutional investor.



The portion of the property that is owned by an institutional investor is rented by the consumer (or Co-Owner). Instead of buying 1, or 1000 properties, and receiving 1 rental on each, Mill Group's Co-Investment model provides Investors with half properties with 2 'half rents' as income (the specific split of ownership can vary).

The economic efficiencies of this new model lie in the much improved net income through the removal of repeated re-letting, redecoration, void periods, service charge and insurance shortfalls. Co-Investment promises a typical net to gross income of 90% or more, in comparison with 65-70% for normal BTL portfolios.

The problems associated with shared equity leases and attendant mortgage difficulties are obviated. There are no fixed staircasing obligations nor are any assumed in the financial structuring of the investment, giving consumers a long term, stable co-investment option.

The Co-investment model will enable a new group of consumers to enter the market as buyers of both new and existing property – which itself will stimulate more new build schemes to be brought forward in these difficult times. It will also enable people to begin the creation of wealth through home ownership and paying their own mortgage on their part-owned home, as opposed to simply paying their landlord's mortgage.

For institutions, the model removes the major risks associated with the residential sector:

- Lack of void periods once the co-investment is arranged.
- Repairs and other running occupation costs can reasonably be passed to the occupier in full. Management issues are minimal and there is a mutual interest in improvements to the property.
- Both the co-owner and Fund investors share capital growth.

Co-owners will be expected and encouraged to look on the property as their own and to purchase out the Fund's interests over time- thereby generating a realisation /reinvestment opportunity for the Fund

MILL GROUP

The model offers:

- Very attractive returns for institutional investors
- Leveraging of new institutional funds into residential property which has long been recognised as a desirable asset class, but which hitherto has been seen to have insurmountable barriers to investment related to tenancy management
- Help with the housing aspirations of large sectors of the population who face the realities of high property prices who are currently badly served by Government initiatives and the mortgage market

Over the credit crunch mortgage finance terms have changed radically, increasing deposits as LTVs on mortgage loans have dropped. Potential homebuyers simply do not have accessible cash to put down deposits of such scale – especially when buying London property.

The average FTB in Q2 2009 in London put down a deposit of £49k, with 80% of these parentally supported to fund this scale of deposit. New home ownership in London is currently only accessible to those with wealthy families. Average unsupported first time buyers are now 37 years old and we risk having a lost generation of homeowners unless new models such as Co-investment become new solutions.

The problems are not constrained to FTBs. Large numbers who bought property in the last four years do not have the equity to move up the housing ladder when family circumstances dictate. This results in big retention and recruitment problem for London employers especially public sector employers. Large numbers of Londoners are income secure but equity poor; co ownership is their ideal vehicle onto or up the housing ladder.

With government funding and mortgage finance drying up housing needs continue to grow. New institutional money will help to bridge the gap. Mill Group's Private Sector Co-investment model is one of the first to be launched and addresses the historical barriers to residential housing investment while still delivering very attractive returns (see Appendix 1).

MILL GROUP

Socially Responsible Investment

Mill Group's Investors in Housing Fund has been described in Pensions Weekly as one of the very rare occasions when attractive investment returns coincide with socially responsible investment. We believe we do this by;

Meeting Government objectives

- Meets the long standing Government policy of encouraging private sector investment into UK residential property (see - Pomeroy Review of Prospects for Private Sector Shared Equity)
- Provides a potential way of accessing a major new investment source of £bns by 2011/2013 when Government resources that have been brought forward to address the current crisis are at a low point.

Stimulating the economy:

- Supports new and moribund housing schemes at all levels in the market, preserving the house building capability so that it survives to build more housing when economic conditions turn again
- Enables all SME's which depend on the house building to return to the market preserving jobs
- Offsets future inflationary pressures now building up because the supply side is drying up
- Encourages homebuyers at all salary levels (both FTB's and existing owners) to re-engage / transact with the market

Meeting Social Objectives:

- Is a sustainable and long-term solution rather than being a response to the exceptional circumstances
- Reduces the risk of a generational divide building up between people whose parents have bought houses and those that have not. Provides the opportunity to share in wealth creation from home ownership for those that would be excluded through not being able to buy 100%
- Encourages suitable use of borrowing matched with available deposits – without pressure to over-borrow to acquire 100%
- Facilitates equity release for those that face financial difficulties and can therefore avoid future repossession
- Enables people to move into permanent accommodation of their choice with an ownership interest they can afford, tackling the new un-affordability issues of lack of cash deposits and Loan to Value levels from mortgage lenders.

Need For Public Sector Leadership

Mill Group looks to government entities to show leadership in supporting the launch of the Investors in Housing Fund with its initial focus on London property. The London Pension Fund Authority will invest up to £50 million, subject to others joining them. The initiative is supported by the Mayor, The Homes and Community Agency, and relevant Government departments.

We are generating increasing interest from institutional investors and others, with the potential to raise significant sums that will have an immediate impact on the UK housing market and the UK economy.

Early adoption of new models is needed by far sighted institutions so that they can prove their value by contributing solutions and options, especially in such a complex and changing market as Housing.

While mortgage lenders are happy with our Private Sector Co-investment few are looking to support innovation given they have limited funds for lending. We look towards government leadership to encourage mortgage lenders to support innovation in the market.

Sir Robert Kerslake – CEO Homes and Communities Agency

"We welcome the product and the innovative way in which it will lever institutional funds into residential housing investment. In our view there is a definite place for this new form of housing tenure in the mainstream market, especially in the high cost areas of London and the South East.

We would be delighted if the local authorities and others who currently have the matter under consideration succeeded in getting this fund underway; it will be a very welcome addition to the mainstream housing options for Londoners, and has the potential to help revive the London housing market with all the concomitant economic benefits that will bring."

Summary

Mill Group's Private Sector Co-investment model is ready to go. Its impact will be immediate and wide ranging. It has all the requirements of scale and can make a substantial contribution to the economy by injecting £billions of new investment. It is socially responsible and can affect the broad spectrum of UK citizens and businesses.

Mill Group has taken the leadership role in this – investing £millions in a fully developed proposition, ready to be launched within months of sufficient investment being raised.

Response to the Consultation

The Treasury consultation has naturally been framed again the background of the recent past and as not been able to allow for new innovations such as Co-Investment.

However, we believe that many old models within PRS, as well as some new models such as Build-to-Let, have a number of fundamental flaws with regards to the benefits to investors and that there are alternative options available which are faster to initiate, will cost less to the public purse and can, in the long run be more effective in delivering the goals of providing a rapid increase in the available housing stock.

Where relevant, we also compare the PRS investment issues with those of Co-investment.

Individual Investment:

Question 1: What has led individuals to invest in new build properties in preference to purchasing and converting existing owner occupied housing?

During the period of exceptionally high growth and easy, low cost availability of lending, not surprisingly, individual investors took advantage of the potentially high returns offered both in terms of capital growth and income. In fact this was a market driven by speculators, both large and small, able to secure a number of properties off plan with small deposits. As easy availability of funds dried up, the speculators have faded away leaving a large number of unsold and empty properties. Take away the potential for dependable capital growth and steady income flows, add the current difficulty of raising funding die to the severe shortage of liquidity, and the BLT model in PRS has lost its sheen.

Question 2: To what extent has the growth of the PRS already influenced the house building industry? How might it do so in the future?

The primary driver for house builders to switch into the PRS market was the expectation that it removed sale risk and gave a short-term return on capital. As the economic downturn has hit lenders, house builders and BTL investors, evaporating risk appetite, developments have largely stopped. A source of credible buyers to pre - commit to purchase units is now required before development commences

Institutional Investors planning to either rent or use the Co-investment model can step in where the individual or small PRS investor has withdrawn.

Question 3: What is the contribution of individual homeowners renting out part of their own home making to housing supply? Are there significant constraints limiting this contribution to addressing housing demand?

Individual homeowners renting out part of their own home is the one sector of the market neither the house builder nor the investor will talk about, and is yet potentially the largest and most readily available stock of accommodation available, at the lowest possible cost to the public purse. One should add to this the large stock of empty properties, especially in urban

areas, and these properties are mainly privately owned and one is left with the best potential utilisation of existing stock.

Above all what is required is a change of perception and attitude towards homeowners who rent out rooms, ensuring that it is seen as an acceptable and as a socially positive undertaking.

Question 4: To what extent have the incentives for individual investment in private rented accommodation changed over the last 10 years and why? Going forwards, what are the key prospects and risks for individual investment in the PRS.

The current primary constraints are the availability of BLT mortgages. The current market conditions have also dented confidence in the capital growth prospects of PRS, which is coupled with an increasing awareness of the risks, both to capital and to income (via voids, maintenance etc.).

Institutional Investment

Question 5: How important are scale economies in management to viability, and what is the minimum lot size required to ensure institutional investment in residential property is commercially viable?

Scale is the key factor for institutional investors. It needs to be recognised that institutional investors have large portfolios, which are allocated across a number of key objectives. To select a particular sector, in this case the residential property market, they need to be sure that scale exists. The importance of scale is also relevant in the sense that it can mitigate management costs and voids, spreading the risk across a wider number of properties.

Timescales and risks are the other key factors. Large Institutional investors will be looking to allocate £200m - £1bn to a market. They do not want to allocate these funds and then have to wait for a number of years before these funds are 'working'. One of the weaknesses of the new 'Build-to-Rent' model of PRS is that not only do the properties need to be built (with all the delays that could entail), they then need to be let, adding to the timelines experienced before any income is being generated. The other key factor for institutional investors is the limited available exit strategies offered by PRS – they need to be sure they have the ability to sell out as investment priorities change.

Net income levels for large scale BTL investments have proven unattractive in comparison with other asset classes, in part due to gross rental levels and also due to voids as well as significant management costs.

For many institutional investors there are easier and more rewarding options than the PRS

Net income is a core issue for institutional investors. It needs to be addressed in a more profound manner than marginally reducing the cost inefficiencies for the PRS asset model through scalability. The co-investment model, on the other hand offers both scale and secure, uninterrupted income.

Scale is achieved by not limiting the investment portfolio to new build home only, and including second hand properties. This enables the institutional investor to spread the risk, invest their portfolios more rationally and more immediately.

The 'built-in' exit strategy of homeowners themselves looking to sell their properties after a number of years provides added security and reassurance for investors. Each time a property is sold, the investors equity stake in that property can either be withdrawn or re-invested.

Co-investment also has the ability to attract both larger and smaller investors, as each portfolio can be properly managed without inherent risks witnessed by PRS investors.

Question 6: What evidence is there that i) the SDLT bulk purchasing rules are a constraint to building up property portfolios, and ii) changes to SDLT rules for the bulk purchase of residential properties would lead to increased investment, either by institutions or individuals, in the private rented sector?

SDLT impact on bulk purchases is modest. However, as an upfront acquisition cost it is undoubtedly undesirable and will lead to some hesitance amongst investors. SDLT also impacts on desirability of breaking up portfolios which is a serious impediment to scale.

Question 7: How might changes to the SDLT rules on bulk purchasing impact on the rate of return on institutional investment in the private rented sector?

The rate of return on institutional investment is related to the savings (and hence in part related to the unit value) and the term over which investments are evaluated.

The impact of 4% SDLT is probably more material in affecting the behaviour of seller as it is more economic to break up portfolios and sell on an individual property basis, enabling institutional purchasers to immediately reduce their SDLT burden from the purchase price.

The lack of scope for residential portfolios to be sold as larger scale transactions is a material issue and a significant barrier to institutional interest in the residential market.

In our experience, institutional investors, rarely have an investment horizon of over 7 years when making initial investment decision . In fact, over this period, we estimate that the 4% SDLT on IIR via co-investment would be 65bp. SDLT does not make a material impact on Investors in Housing.

Question 8: How do the rates of return on investment in the PRS compare to those expected/required by institutional investors?

The PRS buy-to-let or build-to-rent models are not generating sufficient income yield to attract interest on is own - without capital gain being factored in. The principal issue is the significant losses from gross income to net income. The initial gross rental yield is also modest in many parts of the country. With uncertain sustainability of historic capital growth the difficulties of getting long term investors interest become clearer.

MILL GROUP

By minimising to a great extent the impact of voids and maintenance, co-investment delivers minimal losses between gross and net income, making it a more manageable proposition for institutional investors.

Question 9: What factors have prompted the recent institutional interest in investing in PRS, and what changes would be needed to address them?

It is not clear there has been a substantive increase in institutional interest in residential investment amongst institutions. What is clear is that there has been an increase level of hype and PR.

It is clear that the HCA's PRSi promised the possibility of government subsidy/funding support for the build-to-let model and that some institutions/institutional fund managers responded to this when the markets were is crisis. The lack of any tangible support to funds /investors (as distinct from programmes to address negative land value barriers) has been seen to be a disappointment to those closely involved in this programme.

Question 10: What are the key barriers to institutional investment in residential property, compared to commercial property? How could these barriers be addressed, and what evidence is there that such changes would increase institutional investment in the PRS?

Key barriers include:

- no or few precedents and some of those have had poor returns (eg Grainger GMax)
- no or few residential investment funds offered
- unattractive income return (a sought after defensive quality post crisis)
- expensive and difficult management
- voids and unrecovered insurance and service charges
- maintenance costs and hassles
- re-letting costs and redecoration etc costs on re-let
- capital value issues
    - poorly forecast and thin /recent financial futures market.
    - investment indices and total return performance measures only just launched
- unable to invest in scale
    - few funds on offer
    - few assets available to buy in bulk
- delays and risks of new development
    - new build focus for residential investment has downside
    - land /planning and economic viability is challenging
    - risks of delays and cost escalation unquantifiable up front and therefore unattractive
- investment in scale is very difficult to produce
    - a big scale development may not be attractive as a concentrated investment in a particular location (especially in a large unproven regeneration area) few portfolios to buy
- residential fund managers (as distinct from residential asset managers) - there are very few with experience

MILL GROUP

- no residential performance indices used in investment mandates or performance bonus (recent IPD residential index launch may be significant step in this area)
- PR issues
    - risk from dealing with people in their homes - especially when in financial difficulties /repossession.
- valuation issues
    - residential is valued at discount to vacant possession (VP) value when in bulk (commercial property is at premium to VP value)
    - thin and specialist market with history of a variety of lease structures
    - AST's are short term so no residential market in long term contracts – all have re-letting/ economic risk
    - if buy at VP and make income producing then immediate value hit (plus other costs incl. SDLT to absorb) makes unattractive investment proposition.

Co-investment asset model provides most of the answers and overcomes most of the barriers:

- *attractive income return with minimal costs*
    - *low cost and effectively self managed by the owner occupier*
    - *minimal/no voids (properties are sold on with possession to the next owner occupier),no maintenance charges or service charges – these costs are met by the owner occupier.*
- *capital value defined by market forces*
- *extensive historic data available on owner-occupied market performance, and regularly forecast.*
- *investment indices and performance are therefore more predictable*
- *opportunity to invest in scale*
    - *inexhaustible assets available to buy in bulk*
    - *no delays and risks of new development*
    - *new build plays a manageable share of the portfolio*
    - *land /planning and economic viability is therefore manageable*
    - *quantifiable risks of delays and cost escalation*
    - *investment in scale is readily available*
- *co-investment can work in a big scale development without concentrating investment in a particular location, by 'pepper potting' the tenure through the schemes.*
- *PR risk is minimal*
    - *Less risk from dealing with people in their homes - especially when in financial difficulties /repossession – options exist to help those in difficulties by the fund buying additional share of the property, thus releasing cash – positive PR effect..*
    - *socially responsible benefits of residential investment is already established*
- *Valuation likely to be a low/nil discount to vacant possession values as cashflows more akin to commercial property.*

Question 11: What are the key barriers to institutional investment in residential property through UK REITs, and what changes would be needed to address them?

Institutional investors traditionally look for safe, income generating, low risk investments with relatively low operational costs, hence the historic tendency toward commercial property. Residential property investment historically has used AST which is a short term, management intensive structure, with high levels of voids and maintenance cost.

Culturally, the UK resident has been raised to believe in home ownership, with renting providing a short term, flexible tenure that favours the tenant. By contrast, other European Countries (e.g. Germany) have a greater proportion of residents who are happy to rent long term, providing greater predictability of income and security.

Please refer to BPF/PIA submission for a general discussions on REIT rules as they apply to existing models of PRS:

- *The barriers identified in our response to Question 10 are also generally relevant in the context of encouraging the emergence of residential REITs.*
- *Reducing trading/investment is particularly important for REITs.*
- *Changes should also be made to the way the distribution requirement operates and to the potential impact of the profit:financing cost ratio for residential.*
- *The diverse ownership condition should be reconfigured.*
- *The conversion charge abolished or linked to latent gains (rather than portfolio value).*
- *Rollover relief for those selling to a REIT in return for shares would also be helpful.*

Co-investment model produces Schedule A income that is REIT qualifying but a more detailed analysis of REIT rules has been carried out.

Co-investment model does not require regular sales to provide return to investors, though they are likely to occur in practise:

1) *Trading / investment disposals – this is likely to be a critical issue in the decision to use a REIT structure for co-investment funds.*
2) *Interest cover ratio – the REIT rules are less likely to have unacceptable limitations to co-investment funds than other forms of PRS but remains a serious issue.*
3) *Distribution requirement – this rule also impacts on the landlord obligation under AST to maintain and repair property under AST's. Under co-investment this obligation is taken by the co-owner so this rule is likely to be less of an issue to a REIT using the co-investment model.*
4) *Diverse ownership – these apply equally to co-investment model or other PRS models*
5) *Financial barriers – these apply equally to co-investment as to other PRS models.*

Q12. What evidence is there of the likely effects of such changes on new, and existing, UK-REITs investing in residential property? And what impact would such changes have on existing UK-REITs investing in commercial property.

With suitable changes to the REIT rules as outlined in the BPF/PIA submissions and commented above, we would anticipate REITS would be the vehicle of choice for quoted residential funds.

Q13. How suitable are other collective investment vehicles for residential property investment? What are the current barriers to investment through these vehicles?

An offshore unit trust investing in an English Limited Partnership structure is currently the recommended fund structure for a residential investment fund for institutional investors as exemplified by 'Investors in Housing', despite the obvious costs of maintaining the offshore structure.

Please refer to the BPF/PIA submission for more detailed comments.

Q14. How do these collective investment vehicles compare to UK-REITs?

Please refer to the BPF/PIA submissions for comments

Q15. What evidence is there that institutional investment in the PRS would bring real benefits to the sector and the housing market more generally?

Institutions own a tiny proportion of the UK Housing Market in comparison to commercial property or in comparison to other countries in Europe and elsewhere.

The potential impact of institutional investment in UK residential property is substantial and to some extent has been seen in new markets such as student accommodation, sheltered housing and nursing homes.

Indeed commercial property occupiers would be in a totally different position if Institutional Investors did not dominate commercial property investment. They do not have the capital to own their own property.

And in that sense the residential market has exactly that challenge. People, especially FTB's and recent purchasers, do not have the capital to own their own homes.

Co-investment on the other hand allows people to use what capital they have to buy a share in their property, whilst simultaneously providing an efficient investment model for institutional investors to commit long-term funds to the housing market.

There has to be doubt about the ability of BTL models to prove a long term financially viable private rented sector. As such it is extremely important to encourage other models to develop to attract institutional investors into the UK residential sector.

The main issues that have been raised are less to do with taxation or issues that need addressing by Government, and more to do with the very business model upon which PRS is established.

Other models should therefore be explored before total and single-minded commitment is made to this one approach to increasing the housing stock.

We have herewith talked about another model, called co-investment.

MILL GROUP

Appendix 1

The Investors in Housing Fund

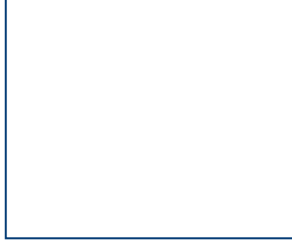
Investment Case

The Fund will initially invest in London residential property, with the view to rolling out the concept across other high cost areas in the UK in the next 5 years.

London residential property has comfortably outperformed all the usual asset classes over the last thirty years and has a very low correlation to equities and bonds. Residential property has been the best performing asset class over the last 30 years.

The base case can be summarised as follows :-

- Ungeared IRR of 12% - 15% for a 5 year fund with up to a 2 year tail.
- Returns post all costs and pre-Founder incentive.
- Fund size: £200m to £500m.
- 18 months investment period.
- Distribution of 6% pa indexed from drawdown
- Fund 12-15% IRR value creation through:
  - Gross rental yield 6%
  - Capital growth projected * 6 - 7%
  - Net profit on sale to co-owner 2 - 4%
  - Costs (transaction and running) -2%
- Key assumptions:
  - Base rental at 6% + RPI.
  - HPI value change over 5 years : 7% pa.* - per JLL Feb 2010
  - Average acquisition discount of 15 to 20%.
  - Transaction costs and fees of 3% of full property OMV.
  - SDLT of 1-3% of property OMV
  - All running costs allowed
  - Exit valuation at 90% OMV VP.
  - Disposal costs and fees of 2%
  - 50% Co-ownership.
  - Average house price £250,000 to £300,000.



MILL GROUP

39 Craven Street,

London WC2N 5NG

t 020 7930 8600

f 020 7930 8608

www.millgroup.co.uk