

Residential property – designed for pension funds

FOR THE PAST 10 ,20 OR 30 YEARS, RESIDENTIAL PROPERTY IS THE BEST PERFORMING ASSET CLASS WHEN COMPARED TO COMMERCIAL PROPERTY, BONDS OR EQUITIES – WITH UNDOUBTED DEMAND AS PEOPLE NEED AND WANT HOUSES TO LIVE IN



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“House prices in the UK have tended to have longer periods of upswings than commercial property, less steep price falls in downturns and a faster recovery period.”

The reality that residential property is a consistently positively performing asset class has especially been true over the past ten years during which most other markets have experienced the rollercoaster of boom and bust.

A market that so regularly and demonstrably outperforms other core asset classes would normally expect to be actively traded in by institutional investors who, one would expect, would want to gain from this consistent market predictability. And yet, this market which is estimated to be worth £3.8trn (more than treble the size of the commercial property market), has just 1% of its value held by institutional investors – compared to 25% of the less well performing £1.2trn commercial property market.

Whilst residential property has not been immune from cycles, the severity of its cycles have in fact been modest in comparison to other asset classes and substantially uncorrelated. High personal gearing levels have of course made past corrections painful to people.

Residential housing market price volatility is less pronounced than commercial property. House prices in the UK have tended to have longer periods of upswings than commercial property and less steep price falls in downturns and a faster recovery period.

Scale is certainly not the issue. With over 14 million owner occupied properties in the UK, there is plenty to choose from. And whilst there is a range of forecasts, there is pretty clear consensus that long term linkage with earnings at above inflation will be delivered – and in the short term some looking to a strong recovery in house prices over the next few years – in line with past performance. The well documented supply/demand

imbalance analyses are showing that demand is for a minimum 250,000 new homes each year which is being met by significantly less than 100,000 new properties for each of the past 3 years. This is a shortfall so significant that it is being acknowledged that supply side delivery will never again be able to match demand levels. Or put another way, prices are very unlikely to fall over any reasonable short to medium term investment period.

Also of interest to investors and Government is that residential values are key to a “feel good” factor that supports spending in the High Street and election successes as a core asset class that uniquely gets Government support if values are challenged.

And lastly the social case for investment in homes is also clear, especially to local authorities that have a direct interest in increasing the scale of institutional investment in residential as this will house more people at various points in the ladder.

Why institutions have not invested to date

Many barriers have been cited to institutional investment in the residential sector, principal of which have been the poor net income returns from the short term letting model, the costs and risks of management and unpredictability of capital growth. Add to this the paucity of residential funds, managers and reputation risks of dealing with non payers and it is clear that a new approach to this market is needed.

This should focus on investment rather than the riskier and opaque world of property development with its attendance planning and land assembly risks, and its inevitable delays and low level of actual investment capacity as schemes take

ages to move into construction. The new Government's decision to devolve planning to local authorities is also feared to delay matters as new powers are bedded in.

Development finance and risk capital is also in short supply for housebuilders and residential developers (including housing associations) making new development schemes less certain of getting off the ground. Again the cuts in HCA budgets will exacerbate this problem.

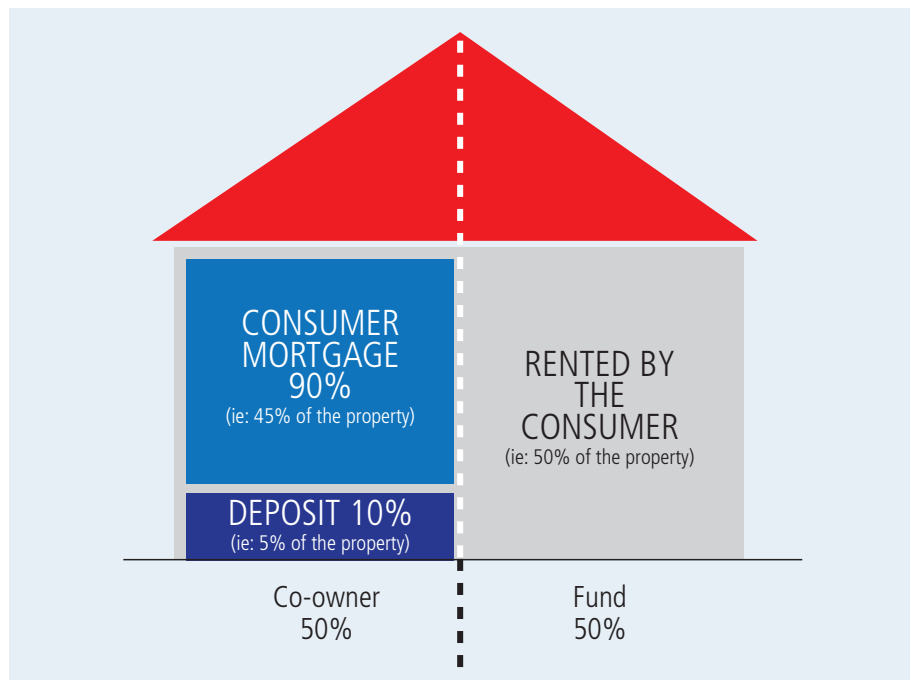
But above all the residential market is constrained by buyers of property – who are unable to fund the much larger deposits required in today's (and tomorrow's) lending market rather than their ability to afford mortgages at current low rates. And this lack of buyers means fewer developments and less supply and so leads to even fewer investment opportunities for investors to access the market.

The co-investment model

In essence Mill Group's Co-investment model is a private sector part rent, part-own model, which provides First Time Buyers (FTB's) and others 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, the model provides Investors with 2 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 "Buy to let" portfolios.

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

The model offers:

- Very attractive cash yields and total returns over long term arrangements
- Scale and low entry risk with both existing and completed new build being acquired
- A new way to access a desirable asset class, but which hitherto has had 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

Co-investment and diversification

The investment case for co-investment is a combination of the general benefits of investing in residential property as a strategic component in asset portfolios and the specific income gains of the co-investment approach.

Co-investment is the only model that offers almost unlimited diversification benefits, providing access across the whole housing stock of c.1.6m properties – new and old – put up for sale each year, and the ability to select



the very best that meet the Fund's pre-agreed investment criteria.

The correlation coefficient between UK house prices and commercial property was 0.64 from the early 1990s to the onset of the credit crunch in 2007 and similar patterns exist in terms of more disaggregated property asset classes. This evidence highlights that residential investment brings additional diversification benefits to property portfolios and to the wider based asset portfolios.

Scale economies tend to be limited in rental housing markets, which is one reason why large investors hold only limited and specialised stocks of rental properties. This limitation does not apply to the co-investment model.

Direct property investment is associated with individual property risk, associated with specific property features or locality an issue faced by both commercial property and rental property investors. Co-investment is not tied to specific property types or locations. It does not depend on the narrow types of property that appeal to potential tenants but to the financial and housing preferences of homeowners. As such, co-investment appeals across the whole market. Yet, while able to provide unrestricted diversification, it can also be designed to answer the specific requirements

that individual investors may have – regeneration of local areas or other spatial measures; specific household types, such as first time buyers or over 50's; or particular property segments, such as family homes or 2-bed flats.

The co-investment model enables investors to capture aspects of the housing market that investment in the traditional private rented sector cannot.

Asset lock-in vs. longevity risk

Co-investment opens up a deep market with little likelihood of the systemic mis-pricing of particular properties – a characterisation which weakens when it comes to blocks of flats or investment portfolios of residential estates – typical of rental properties held by property companies and investment funds. These types of properties are small in number especially in a particular local market and few are traded within a specific time period. As a result, it can be difficult to sell them on a timely basis or to accurately place a valuation on them.

Illiquid markets impact on the two forms of returns, namely net rental income and capital appreciation - the latter being the most significant proportion – which is only a paper return until the assets are sold. A continual realisation of residential assets turns the investment more closely into a trading one, with

resultant high transaction costs and exposure to housing market volatility. This flow of returns is unattractive to investors that need to match future returns from assets with future liabilities, as in the case of pension funds.

Co-investment offers a different approach. Many of the acquired properties will be sold in part or in full over the course of a given time period adding a greater degree of liquidity to expected asset capital appreciation. The trades are distinct from property company or portfolio trades, as they are between home owners, where the majority of the costs are borne by the participants, or are made to existing co-owners raising their shares of the properties they already co-own – resulting in lower transaction costs and more steady profiles than those open market sales occurring on vacant possession or with sitting tenants.

With no time limitation on a diversified Co-investment Fund, and with net, fully realisable rental incomes rising in line with RPI and capital appreciation moving in line with HPI – almost always in excess of RPI – over time, this creates a net income flow to realise pension demands in the immediate term and for the longer term.

The residential property market is ideal for pension funds looking for solutions to mitigating longevity risk. Co-investment provides a realistic model for consideration.

Mill Group has launched the Investors in Housing Fund comprising a £200million equity raise and a minimum 5 year lifespan. The Fund is 100% residential, focussing initially on London and the South East. It offers income return of 6%pa after costs and projects an ungeared total return of 10 to 15% IRR over 5 years depending on house price inflation and other factors and is based on the co-investment model.