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Residential funds: as safe as houses?

By Claer Barrett

Buying units in a specialist residential fund offers a much lower entry point for investors than a traditional buy-to-let. It also appears to be less risky – investor's funds are pooled together to build up a portfolio of properties, with purchases, lettings and voids carefully managed by a professional team. Of course, this comes with a management fee – but investors are spared the hassle of 4am phone calls about burst pipes.

Nor is there anything new about this investment model. Just look to the US, where real-estate investment trusts (Reits) are commonplace. These listed vehicles own great portfolios of residential property, typically apartment blocks leased to individual tenants. Investment yields are far from racy, but Reits are revered as steady income providers, the majority of income being paid out in dividends.

Unfortunately, current UK Reit legislation does not permit residential investment. This is a lost opportunity, as the Reit model offers two important qualities for private investors that the current crop of funds do not: sound regulation and instant liquidity.

In our 'structural survey' of residential investments available to private investors (see part three of this feature), it's obvious that necessity is the mother of invention. The buy-to-let property club may rightly be dead, but its ghost has been brought back to life with some of the puffy marketing surrounding certain investment products.

Last time around, naïve investors were seduced into buying off-plan properties they'd never seen, at values they couldn't hope to understand. This time around, investors are being asked to part with substantial amounts of cash, often with no clear idea of what the manager will end up spending it on. Glossy brochures may appear to offer compelling investment arguments, but they are no substitute for diligent research and questioning on the part of investors.

Most of the private funds actively raising money are closed-ended vehicles, which require a three- to seven-year commitment from investors. Many of the providers have little track record as fund managers from which to judge their potential. Therefore, the biggest risk is being unable to get your capital out if the manager fails to live up to his or her promises.

The tag of 'suitable for sophisticated investors' is applied to these kinds of products – and for good reason. A minimum investment of more than £25,000 is not uncommon – be prepared to do your homework before making a commitment.

As safe as houses?

The returns that fund managers are targeting might look good on paper – but how realistic are they? In the last boom, buy-to-let was commonly regarded as a bet on rising house prices. Investors were not attracted by thin rental yields and the challenges of managing a property – capital appreciation was the end-game.

However, the market is moving fast, and many funds that claim to be able to source 'discounted' or 'distressed' property may struggle to find suitable deals given the extent of competition and limited amount of stock on the market.

Many funds are focused on central London – an area totally out of reach for the average buy-to-let investor or owner occupier – but don't be fooled into believing there is more money to be made at the glamorous end of the market. Tenants paying top-end prices expect top-end service. Invariably, higher management costs will eat into returns.

Offering refurbishment to boost 'upside' is another common strategy. One fund touting for cash at a recent property event even claimed it would source large one-bed properties capable of being split into a two-bed to enhance rental returns – which begs the question: why would nobody have seen the potential for conversion before?

"It will be interesting to see how many of these funds come to market," comments Lucian Cook, director of residential research at Savills. "The first issue is raising capital, but the second is finding stock to buy. The banks have dealt with repossessions very differently this time around, and low interest rates have limited the amount of distress."

Away from capital-intensive auctions and the vagaries of the private funds market, investors should not forget that there are two compelling listed plays that offer exposure to the residential rental market: Grainger and Unite.

The bigger picture

Private funds are not the only group drawn to the investment prospects of residential property. Major UK institutions are also keen to increase their exposure to the sector.

Today, UK institutions hold a pitiful £2bn of residential property. This pales in comparison to the estimated £200bn size of the UK buy-to-let market, which boomed as the result of cheap mortgage debt. As the graph below shows, risk adjusted returns from residential property have outperformed offices, equities and gilts for the past 30 years.

Residential rules



Aviva will shortly launch a £1bn residential fund for institutional investors, and Legal & General and Schroders have also expressed interest. This scale of investment, coupled with institutions' financial might, means they will develop property for rental; so the movement has been branded 'Build to Let'.

Crucially, there is also growing political pressure to 'clean up' the private rental sector. The Homes and Communities Agency has received 64 expressions of interest from developers and institutions since it launched its Private Rented Sector Initiative (PRSI) in May.

"Of course it's a political vote winner to say 'own your own home' rather than 'rent one', but right now very few people have got enough money on the table to get on the property ladder," says Liz Peace, chief executive of lobbying group the British Property Federation (BPF).

"Institutions are not there to act on the social whim of government – they need to make money for their investors," she says. "It doesn't matter whether that's through investing in offices, shopping centres or homes, but the government could encourage greater investment in that sector by offering stamp duty amendments which would cost the Exchequer next to nothing."

Building up momentum

The smaller institutional funds are also showing a high degree of creativity. Launched last week, Mill Group's £500m Investors in Housing Fund plans to acquire residential property through a co-ownership model, striking long rental agreements with tenants who buy part of their home, and pay rent on the rest. The fund is not open to private investors, as the minimum investment is a cool £10m.

"We've had a great response to the launch, with many people commenting that the fund is an great alternative to buy-to-let, but there are too many restrictions and regulations at the present time to open it up to private investors," says Mill Group director Mike Wisgard.

Given the vagaries of the private funds market, how long will it be before an institution launches a suitable model for private investors? "This is my biggest frustration," admits Rob Weaver, head of residential funds at Invista Real Estate Investment Management. He manages a £500m residential portfolio of 1,500 properties for institutional clients.

"The institutions are generally reluctant to invest in residential full stop," he says. "The legacy of regulated tenancies still haunts them, as they lost a lot of value. But as an asset class, residential property is the top performer, and it should be there. The buy-to-let industry is worth £200bn, yet it is a cottage industry. Because there is no convincing alternative, the public has voted with its feet and gone down the buy-to-let route. With this avenue closed off to most investors, an open-ended residential fund could clean up."

Bye buy-to-let

"There has been a surge of private money coming into the auction rooms, but none of it has been borrowed from a bank," says John Barnett, founder of London auction house Barnett Ross. This is not likely to change in the near future – the proposed regulation of the buy-to-let mortgage market by the Financial Services Authority could shrink the number of loans on offer even further.

"The buyers in the sale room are wealthy individuals who are frustrated with low bank rates and want to invest in something they feel comfortable with," Mr Barnett adds. He has little truck with fund managers who think they can buy residential distress. "It's all talk," he rebuffs. "Most of those funds have yet to invest a penny. When they do, they will find that not many people want to sell their properties. If they're getting an income, why sell it? Distress isn't coming out from the banks; there is very little repossession activity as they don't want to take losses."

Other property investment experts attest that investors are keen to buy, but accessing product at sensible levels is difficult. "Are any of these funds actually buying properties, or are they just talking about it?" asks Neil Young, founder of the Young Group, a respected London residential investment vehicle. "There's still money around. We regularly have clients coming in with £100,000 saying we'd like to buy." This, Mr Young says, is the minimum amount of capital needed to invest in London. A few years ago, the

average client could access the market with less than half of that amount. "People have got to put much more money in, and are frustrated at the banks taking such a wide margin," he adds. "Plus, we are not seeing the high-yielding opportunities that one might have expected in the current market. If you're hoping for 30 per cent discounts and 8 per cent yields, they are not out there. It is very difficult to find a yield over 6 per cent in London."

The answer? Getting creative with deals. Mr Young is in the process of pooling several clients together in syndicates to fund the development of small residential schemes of five to six units where planning is in place. "Finding the right people to deal with takes time, as quality is so important," he stresses. "We had one approach from a developer recently, and went to see a previous development they had built. We found we had to say no."

Investors also find they are outbid on entry-level properties. "The market is dominated by first-time buyers funded by the Bank of Mum and Dad – and what's more, they can get much better LTVs and interest rates," Mr Young says. "In this sense, Mum and Dad are investors in their own right. They clearly take the view that the residential market will come back, and they're getting a derisory rate on their savings, so they are happy to step in to the breach."

All told, buy-to-let is far from dead – it's just being reinvented in multiple new investment forms.