

# Housing association involvement in market renting

## An overview of best practice

### Key findings and implications

The private rented sector has been attracting a growing amount of interest over the last few years from a variety of investors including housing associations.

Housing associations conduct market renting for a variety of reasons. At one end of the spectrum there are associations who are approaching market renting in an identical way to the private sector i.e. profit maximisation. At the other end are those who see it as a natural extension of their core business.

Although it is not reasonable to expect housing associations to have exactly the same motivation as the private sector it can be argued that the less profit driven an association's market renting operation, then the more it becomes a risky extension of their core activities.

Housing associations with existing market rented operations are approaching the sector in a broadly proficient and diligent manner. Most have clearly considered the differences between the market rented and social rented sectors. There are, however, areas for some refinement in business practice.

It was unclear whether many housing associations have fully thought through why they are embarking upon market renting and the precise objectives they are seeking to achieve. Stated reasons for becoming involved tend to be largely narrative.

It is important that housing associations embarking upon market renting have realistic and measurable goals, preferably stated in financial terms.

If investing to generate surpluses or for capital growth then the business plan needs to establish how these returns are to be realised and when.

Developing property to let at sub-market rents brings greater risks for lower levels of return and these should be quantified and justified.

Most housing associations had identified the need to be market driven in terms of ascertaining the nature and level of demand for new rental stock in a local area. They also recognised the need to involve lettings and management personnel in the design of new rental schemes.

Most housing associations did not view their market rented assets collectively and did not have systems in place to review the financial performance of the business on an ongoing basis.

As housing associations develop their market rented businesses there will be a need to invest in systems to deliver comprehensive and informative asset management information against which to benchmark financial performance.



## Background

This Sector Study presents the main findings of research carried out by FPD Savills for the Housing Corporation's Lead Regulation Unit (LRU).

The Housing Corporation does not seek to encourage or discourage housing association entry into market renting. This Sector Study aims to increase understanding and awareness of the market rented sector and to provide a clear framework of 'best practice' in market renting. It can be used by housing associations already involved in market renting to assess how well they compare with this best practice, and by those considering involvement in market renting to assist in sound planning and decision making. The Housing Corporation's regulatory staff will use the framework as the basis for assessing whether involvement in market renting by individual housing associations complies with the Housing Corporation's regulatory requirements.

In order to test this framework of best practice, the research encompassed lengthy interviews with a sample of ten housing associations who were at various stages of developing their market rented operations. The associations were located across the UK and ranged from those with group structures to small associations operating in one local area.

## What is market renting ?

In the Housing Corporation document 'Regulating a Diverse Sector', market renting is defined as a non-social housing activity and as such, housing associations are required to comply with the Housing Corporation's Governance and Finance Standards.

For the purposes of this study we assumed that market renting applies to businesses which own and let residential property at full open market rents. As such they will be subject to tenancies which are either Assured, Assured Shorthold or Company lets.

Private sector investors only engage in market renting for the purposes of

generating profits and maximising returns. Although they are attracted by the income stream that residential property generates they achieve a significant proportion of their returns from trading property, either through the sale of single assets and standing investments or the sale of undeveloped sites.

Housing associations conduct market renting for a variety of reasons. Some approached market renting in an identical way to the private sector. Others see it as a natural extension of their core business. The risks associated with the various reasons for embarking upon market renting are therefore different.

## Overview of the private rented sector

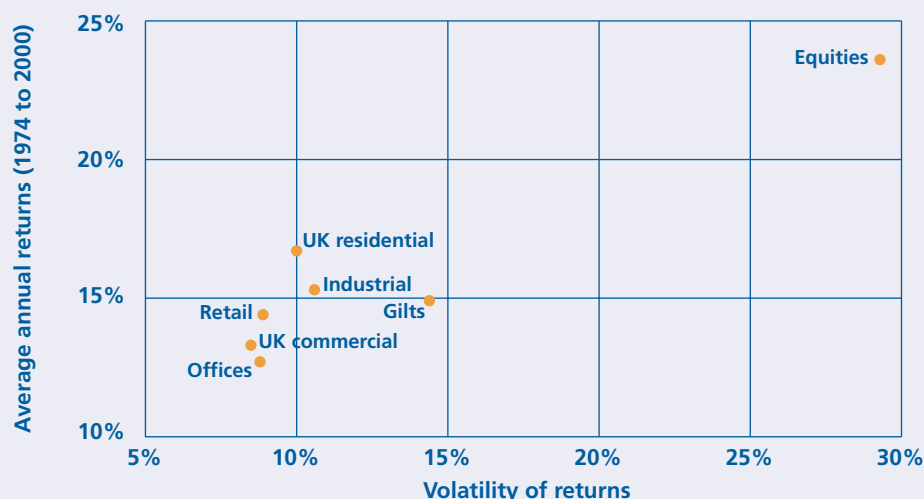
The private rented sector (PRS) has been in flux for the last century with various factors and forces shaping its size and composition.

The PRS we have today is small, has a fragmented ownership and contains generally poor quality, older aged stock (only 8% of the stock was built since 1985). The distribution of rented property is also heavily skewed towards London and the South East which together contain over a third of all privately rented property. The main sources of tenant demand are from single households and people aged under 29 years.

The underlying drivers of demand are strong. Based on the latest DTLR household projections to 2021 it is estimated that £2bn of new investment each year is needed in the PRS to meet the potential future demand for private rented accommodation. This level of investment is highly unlikely to be met in the short to medium term and associations are well placed to provide stock to this potential unsatisfied demand.

For the private sector, in particular UK and overseas institutions, it is the risk-return profile of the UK residential sector which is the major attraction. The fundamental driver is the fact that, over the long term open market rents should rise in line with earnings (this has been the case in the USA). For institutional investors with future

**Figure 1**  
**Risk-related profile**  
**of residential**  
**property compared**  
**to other assets**



liabilities such as pensions, investing in an asset whose underlying performance tracks earnings has great appeal.

Furthermore, the risk return profile of the UK residential investment market looks attractive relative to other assets. Figure 1 shows the long run risk-return profile of residential property versus other assets. The chart shows that residential returns are generally less volatile than other assets whilst providing slightly higher average returns over the long term. It is also important to note that the level of average returns from the various property assets excludes the impact of gearing.

### The current players in the PRS

As well as housing associations there are a number of different types of investor who are currently active in the PRS. Private individuals hold the majority of private rented housing stock (c.60%) and their interest in the sector has increased significantly over the last few years following the increased availability of buy-to-let mortgage finance.

Corporate investors only own a small proportion of private rented stock although they have become increasingly active in the sector over the last few years. They fall into various sub-groups including established residential investors (e.g. Grainger Trust),

newly established residential investment companies (e.g. Leadenhall, Pemberstone) and institutions (e.g. Schroders, Aberdeen Investors and ING Real Estate). All the various corporate investors are seeking to maximise returns either to shareholders or co-investors.

Despite the large potential demand for rented accommodation, the biggest problem facing all residential investors is a chronic lack of investment stock. Faced with a lack of suitable stock, investors are having to resort to other routes in order to grow their portfolios. There are two main options; 1) purchasing units off-plan, in bulk from housebuilders; and 2) acquiring land/sites in order to develop their own stock.

This latter, “build-to-rent” route is becoming far more commonplace. It provides investors with bespoke, high quality, management-efficient accommodation tailored to specific tenant groups. More importantly, it can be developed in locations where tenant demand is strongest. Those associations with development teams will be in a good position to consider the “build-to-rent” option in order to provide privately rented stock for any market rented operation.

### Why consider market renting ?

Before setting up a market rented operation and considering all the risks involved in that process it is important that due consideration is given as to why the housing association wants to become involved in the sector and exactly what they want to get out of it. It is important that they can present a series of cogent reasons for becoming involved as clear aims will inform the development of the business. If financial returns are considered relatively unimportant, as was the case for some of the housing associations which were interviewed, then close examination needs to be given to the reasons for embarking on this form of diversification and understand the extra risks involved.

From the fieldwork it was unclear whether some housing associations had fully thought through why they were embarking upon market renting and the precise objectives they were seeking to achieve. Whilst all the associations interviewed were able to state clear reasons as to why they were engaged in market renting, these reasons tended to be largely narrative.

Few housing associations had made a strong financial or cogent holistic case for their involvement in the sector. This is important, as market renting, by its nature, is more risky than letting to those in housing need. Indeed, it was not clear whether associations have quantified what they want in return for this increased risk exposure. Although it is not reasonable to expect associations to have exactly the same motivation as the private sector we would

argue that the less profit driven an association's market renting operation, then the more it becomes a risky extension of their core activities.

Housing associations who are actively interested in becoming involved in the sector should address the list of questions set out in Table 1 below. Although simple, this process of justification is very important as the results will inform the shape and strategy of the whole operation.

Once the initial review has taken place then the association needs to consider in more detail how it will approach the various aspects of running a market renting operation.

### Key areas of best practice

The best practice framework which was developed as part of this research was based around the following six key areas:

- A. Strategy and business planning
- B. Organisation
- C. Acquisitions and development
- D. Tenant and property management
- E. Asset management
- F. Financial management.

We have set out below a review of the key points under each heading and included comments on how well associations are addressing the most important issues.

**Table 1**  
Questions to consider before embarking upon market renting

- 1 What is market renting ?
- 2 What do we want to get out of it as an organisation ?
- 3 Why should we consider this form of diversification ahead of other options ?
- 4 What is the opportunity cost of not doing it ?
- 5 Do we recognise the differences between market and social renting ?
- 6 Is market renting compatible with our overall business aims and objectives ?
- 7 Are we doing it because it is flavour of the month ?
- 8 What are the similarities and differences with our core businesses ?
- 9 Do we have the necessary skills to do this ?
- 10 What are the major areas of risk in becoming involved in the sector ?

## **A. Strategy and business planning**

Housing associations are clearly experienced in developing strategies and business plans although the nature of market renting means that many of the core assumptions will differ markedly from a social rented business plan. Furthermore, it is important that the business plan reflects the aims of the operation. For example, if investing for capital growth then this needs to be explicitly allowed for within the business plan and the correct measures of value will need to be employed.

We have set out below the key points that need to be addressed in the development of a robust strategy and business plan for a market rented operation.

The initial review outlined above will provide the core inputs for the main elements of the strategy. These will include guidance on:

- aims and objectives of the operation
- sectors of the market to be targeted
- geographical area of operations
- proposed scale of the venture
- how property will be sourced
- target tenant groups
- funding sources
- proposed exit route
- organisation of the operation
- relationship to parent/group
- personnel needed to run the operation
- financial performance criteria

With the outline strategy in place a formal business plan can then be developed to see if the overall objectives of the operation are achievable. The most important assumptions in a market renting business plan are:

- assumed running yields — gross and net
- rental growth
- capital growth
- voids
- tenant turnover
- arrears and bad debts
- management & maintenance costs
- other costs
- tax and financing assumptions
- the anticipated duration of involvement

### *Business planning assumptions*

The major differences between a housing

association business plan and private sector business plan will come in the assumptions on capital growth and rental growth.

Capital growth is not generally included in associations' business planning assumptions for general needs housing whereas we would expect a private investor to allow for a limited amount of capital growth.

Conservative growth assumptions should not add unnecessary risks to the business plan. However, long term capital growth assumptions in excess of 1.5% p.a. (real) may start to make the business plan look either very attractive or cover up any deficiencies in other areas.

Similar comments apply to rental growth assumptions. Although there is little data on long run open market rental values, over the long term, rents should rise in line with earnings, which have tended to rise at 1% to 1.5% above inflation. However, over the property cycle, rental growth can fluctuate quite significantly and this will need to be considered in the business planning exercise.

We would expect a private investor to assume that, on average, voids would run at around 5% p.a. Having said this, for a newly built, fully let portfolio one would not expect to see voids above 5% and a target of 3% to 4% would be a more useful indicator.

The housing associations interviewed had a clear view on management and maintenance costs which they had fed into their business plans.

It is important that a consistent measure of gross and net yields is used throughout the business planning and appraisal process. The gross yield represents the gross rent receivable from the portfolio expressed as a proportion of total asset value. The net yield represents the return after the deduction of all costs from the gross rents receivable associated with letting, managing and repair of the property. There is no standard definition of what costs should or should not be included in a net yield calculation. The current average gross yield across the UK is 9.1% with the net yield being 6.6%. Figure 2 shows how the gross and net yields from UK residential property have varied over time.

Voids, bad debts, arrears and management and maintenance costs will vary considerably over time. All these costs should reduce the gross receivable rents by, on average, 20% to 30%. Thus a business plan that reduces the gross yield by less than 20% is probably not counting all costs, or they are too low. Where the percentage reduction is higher than 30% costs may have been over stated.

### **B. Organisation**

The housing associations which were interviewed had a variety of organisational structures. Some market rented operations were run as separately branded companies within a group structure whilst others were more closely integrated within the core business. Most associations had addressed the organisation of their market rented business in a diligent manner and had considered the cultural differences between operating in the market rented and social rented sectors. Many had employed staff with private sector experience, especially in the field of lettings.

### **C. Acquisitions and development**

The acquisition and development process posed few problems for those associations with in-house development teams. However, the nature of demand for market rented stock, where the majority of tenants rent out of choice, is an issue which needs to be addressed in the appraisal process. Stock that is developed or bought for market rent will need to meet the needs of

local tenants. It is important that local market research is carried out for each development and that the lettings personnel have a full input into the layout and design of any schemes that are developed.

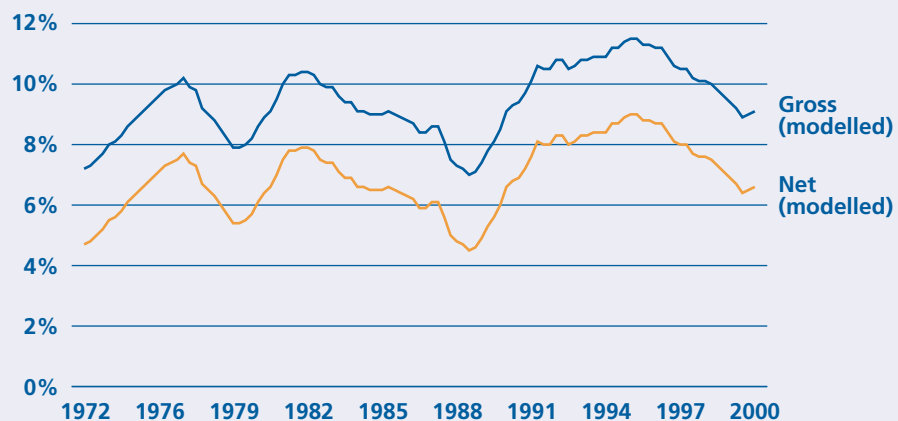
### **D. Tenant and property management**

The majority of associations interviewed had clearly defined tenant policies and a standard approach to tenant selection and credit referencing. Procedures were also in place for those tenants falling into arrears or those with bad debts.

Quality and service and responsiveness to tenants problems and questions are of primary importance in the market rented sector. Indeed, we would recommend that an association's approach to tenant and property management should be formulated and documented so as to reflect how the market rented operation will meet its client requirements. This sets the benchmark for quality of service which everyone within the operation can focus on attaining.

Perhaps the biggest decision for an association is whether to run the property letting and management process in-house. This needs to be considered carefully as the 'capture' of tenants is crucial in keeping voids to a minimum. At present housing associations are not the obvious choice for private sector tenants and as such most associations tend to conduct the ongoing management in-house whilst using external lettings agents to source tenants.

**Figure 2**  
Variation of gross and net yields from UK residential property over time



Once the systems have been established and the portfolio is running it is very important that the lettings and management team meet regularly to review the management performance of the portfolio. Ongoing management reports should be available to all key personnel and should detail, property by property, details of bad debts, arrears, voids etc. with notes on action points and status. This activity is very important and is a real driver of financial performance from a residential investment portfolio. It is often an overlooked/under-developed part of the day-to-day business of property management.

### **E. Asset management**

Effective asset management was the least well considered aspect of the market rented operations we visited. Having said this, one or two organisations were very clear on where their market renting operation fitted into the overall asset management structure of the business.

A possible reason for the weakness in approach to asset management is that housing associations have yet to view their market rented stock as a commodity which can be bought and sold to meet the aims of the operation. This is a very different approach compared to social rented stock where the intention is, generally, to hold stock in perpetuity.

Most of the housing associations interviewed stated that they were looking to use their market rented stock as a way of generating surpluses or assets which can be used to support or subsidise their core activities. The framework for how this value was to be delivered was not in place in most cases. Indeed, the majority of associations visited did not come up with any specific financial targets against which to benchmark their market rented operation. This was the single biggest gap in business practice that we encountered during the course of our fieldwork.

Private investors identify the returns they are seeking to achieve by investing in an asset and then monitoring the performance on an ongoing basis to ensure those returns are delivered, usually in the form of an Internal Rate of Return (IRR).<sup>1</sup> Only a small proportion of housing associations use IRRs to inform investment decisions yet they are relatively simple to add to a business plan or appraisal model.

Despite many of the housing associations saying that a key objective was capital growth, only one had considered in detail their future exit route, i.e. when and how they would realise the capital growth. This was one of the primary reasons behind our earlier comment that we believed most associations are unclear about why they are entering the market rented sector and what they want from their involvement.

Effective asset management is vital if the financial performance of the market rented operations is to be optimised. The key to effective asset management is the collection and analysis of operational data and market information. Analysis of the relevant data will help identify under-performing stock or property where imminent future expenditure will adversely affect the ongoing performance of a particular asset. In both cases the asset manager may decide to crystallise the capital gains from the stock and look to re-invest the funds.

### **F. Financial issues**

The financing of market renting is a major issue for housing associations who tend to have limited amounts of equity. Appraisal models where traditional development finance is available will often present a relatively unattractive rate of return as finance charges tend to be high and the prospects for a swift expansion of the business will be limited.

Many associations have been approached by organisations offering funding via sale and leaseback agreements. These are arrangements which need to be entered

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*1: An internal rate of return is a measure which is used to make comparisons between alternative investments. In property terms it is the rate of return between buying and selling an investment allowing for all inflows and outflows of cash as well as the capital growth in the asset over the investment period. For market rented operations with detailed, year by year, business plans and property appraisals it should be relatively easy to compute the IRR.*

into with care and it is important that associations understand the value they are adding to the overall deal. Long term rental guarantees reduce the risk profile of an asset and can greatly enhance its value. It is questionable whether associations get to see much of the value they add to sale and leaseback agreements.

### Overall conclusions

There are a number of issues which need to be addressed by housing associations who are active in the market rented sector. As we have already commented, it is important that associations implement asset management systems for their diverse operations as the nature of this business makes it important that the financial performance of assets is monitored on an ongoing basis. Associations will need to inform this asset management approach against a medium to long term outlook for the UK economy and housing market.

It is clear that many housing associations have seen highly attractive rates of return from their market rented operations over the last few years, especially those in the south of the country where house prices have risen very quickly. It is important that associations have flexibility in their investment strategies which allow for far less buoyant conditions in the housing market. Very few of the associations we interviewed had any such strategies in place.

The strong growth in house prices has driven down yields and this will make it increasingly hard for housing associations considering entering the sector to generate sufficiently attractive rates of return if they are relying on traditional sources of finance. This raises the issue of how low levels of return need to be for an association to embark upon market renting and whether returns may be higher from other forms of diversification. As we commented earlier, the less profits driven an association's market renting operation, then the more it becomes a risky extension of the core business.

Having said this, housing associations are well placed to develop market rented operations which offer useful synergy with their core product. As government policy continues to move towards the mixed-use, mixed community, urban regeneration agenda, having an in-house market rented operation may be a very useful asset to draw upon. Indeed, many associations have market rented stock which private investors would be proud to own and run.

What housing associations need to focus on in the short term is a review of their key objectives from market renting and the systems they can implement to monitor and drive the performance of their assets in order to generate surpluses for either their core business or the continued expansion of their diversified operations.

### Further information

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