Reimagine Places: Employer backed build to rent

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Let's reimagine...

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This paper is one of a series of thought experiments in which we imagine new ways for local and sub-regional bodies to deliver public policy goals and boost local economic growth.

Many of these ideas will explore the growing opportunities for productive collaboration between public and private bodies in places as decision-making powers gravitate towards the city-regional level. Many will draw on the huge potential of data and digital technologies, 'big data' and analytics techniques. Others will involve tapping into the power of markets, new incentives, transparency or the wisdom of crowds. In every case, it involves fresh ideas. To channel our thinking, we imposed three rules.

01 Ideas must be designed to produce better public outcomes without increasing the burden on the taxpayer.

02 They must align with the government's philosophy and headline policies.

03 They must be realistic and deliverable.

But within these rules we want to step outside conventional thinking, and test out new ideas. We want to stretch ourselves, applying new technologies and techniques to solve complex problems. We are not calling for a specific future – but we are reimagining it.

What do you think?

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Reimagine build to rent: employer nomination schemes

Despite the salary premiums offered by London employers, many young professionals struggle to afford accommodation in the capital. Jan Crosby explains how a different approach could help both employees and employers, whilst providing new opportunities for developers and investors.

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We aren't building enough houses in Britain and haven't been for decades. Why not? And is there a big idea which can unlock the supply and dramatically boost housebuilding? Jan Crosby thinks he has the answer.

With the average London home now changing hands at nearly half a million pounds[1], many young professionals have little hope of buying their own place. There is a lack of discounted 'key worker housing' for public servants[2], and the average salary of those buying through its shared ownership schemes is over £38,000[3] –well above the median London salary of £35,457[4], let alone the earnings of graduates beginning careers in fields such as teaching, business services and the media.

To attract staff, many employers must offer 'London Weighting' premiums: a newly-qualified teacher, for example, earns an extra £5,000 in inner London. But much of this cash simply funds the season tickets required for long commutes from the outer suburbs, or helps support high rent levels. Even the portion that supports house purchases simply pushes more demand into a supply restricted market, helping to exacerbate the underlying pricing problem. Some may have expected the Brexit vote to dampen house price inflation, but in August it was running at 5.3%[5] in England – way ahead of wage growth that hovers around 2%[6].

As with the government's 'Help to Buy' schemes, London Weightings neither stimulate additional housebuilding, nor solve the affordability problem facing young graduates. Ultimately, the solutions must lie in boosting supply, not in subsidising demand.

Why aren't developers building more home to sell?

So why aren't developers supplying the market need and building in bulk? The explanations many turn to is a shortage of land, planning restrictions or a lack of construction workers. These are factors, but, in my opinion, they are far outweighed by a more important and understandable disincentive to build at scale: **market absorption pricing**. The economics of house building work like this: the developer who bids the most for the land wins the deal. They make a bid based on the price they think they can sell the homes for, deduct their margin and build costs and the result is the maximum they can pay for the land. In a competitive auction process, there is tension in this figure and the developer who offers the highest price will win the land auction.

The price offered will be based on an assumed plot density and selling price. This selling price is typically based on existing house transaction pricing in that area. This local comparable pricing is from the natural equilibrium in demand/supply in the area. Selling quicker may need lower pricing to attract the demand – which would reduce the developers return based on their competitive land price. Therefore, developers will only develop the land when they are confident of achieving their forecast price for the finished properties. But the rate at which the market can absorb new properties is limited – and also shared with the second-hand supply. If developers over-supply the market, i.e. build faster than the rate at which the market can absorb, they create a glut and the price will drop. This explains why we see even large developments released in phases of a few dozen plots at a time.

Is Build to Rent the alternative?

In previous papers, we have emphasised the need to take a more organised approach to building rented homes – thus cooling the housing market, whilst providing accommodation near employment centres and supporting labour mobility. The model works well overseas: in the USA, a well-established 'Build to Rent' (BtR) market churns out high-quality accommodation for families and individuals. Meanwhile, we've seen the development of a thriving market in dedicated student accommodation. This now turns over more than £5bn[7] a year – and its growth provides lessons for how to make BtR viable in the wider rented sector.

Currently, selling houses can deliver a higher return than renting them: construction can be funded with a short-term loan, and the investor's exposure ends as soon as the house is sold. Meanwhile BtR investors incur new costs every time a tenant moves out or fails to pay the rent. And if they can't fill the place in time, they're lumbered with an empty property. With net rental yields lying at sub 5%, there is less buffer available for the risk of lower rents or higher operating costs in what is a relatively immature sector. There is a weight of funds looking to invest in the BtR sector, but achieving the right balance of risk for the lower returns is tough for more institutional risk averse investors.

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The big idea: the role of employers in reducing the risk for rental

To kick-start investments in 'Purpose Built Student Accommodation' a few years ago, higher education institutions began offering investors 'nomination agreements' – block-booking large numbers of rooms, then leasing them to their students. A similar model could work for consortiums of major employers, enabling them to offer their staff high-quality accommodation and dramatically boosting their offer to prospective employees.

At a stroke, this approach would free investors of both the risk of voids, the credit risk of tenants defaulting and the costs of finding and contracting for renters on the open market, making BtR far more viable – and providing a volume of guaranteed demand that would permit investors to build rental properties at scale.

If those savings were put through the developer's financial model, our analysis shows that it should be possible to provide a discount to market rent for employees, while maintaining the price paid to the landowner and preserving the margins for developers. And if the employer is offering discounted accommodation then it is unlikely they will ever be called on their guarantee.

So, finding tenants would not be a problem. And purpose-built properties would have communal areas, cafes, high-quality facilities and fast Wi-Fi. They'd bring together young professionals from similar employers, helping people new to the area build their social networks. They'd rescue employees from London's cut-throat rental market, with its insecure tenancies and poor service standards. They'd be located near work – cutting the time and money lost in long commutes. And with a large employer behind them, the tenant's administration burden is eliminated along with the need to raise a deposit.

The financial model

In some cases, employers might fund such developments themselves. Borrowing at lower rates than those available to many buy-to-let landlords, they could undercut the wider rental market. Or they could invest company pension funds, cutting out the middle man. But the main interest would probably come from institutional investors, which are keen to back BtR, but are cautious of management risks and the uncertainty about demand/pricing.

In areas such as Canary Wharf and the fast-growing employment hubs in East London, investors could bring together groups of major employers willing to sign nomination agreements – supporting the big developments required to spread the costs of additional facilities such as leisure, hospitality and retail services. Given employee consultation to ensure that new buildings meet people's needs, the offer of great accommodation at below market rates would help employers to strengthen staff recruitment and retention. And developers could release properties in major new developments without worrying about flooding local housing markets, speeding up the homebuilding cycle.

There would be further advantages for public sector employers, many of which have surplus or under-used land and can borrow at very low interest rates. The discount to market rent could be 35% or more with a public sector guarantee. Imagine the difference that would make to teachers, nurses, prison officers, social workers etc.

Winners on all sides

This concept has already proved itself, helping to catapult the student accommodation market from small beginnings to a major industry. Amending the model to serve employers and young professionals would promise big benefits to all concerned.

For employees, it would provide high-quality homes near work – with great facilities, and at less than market rental rates.

For employers, it means a stronger offer to new recruits, and confidence that London's salary premiums are doing the job for which they're intended.

For investors, it would reduce the risks of Build to Rent and generate economies of scale – providing the long-term investment opportunities sought by many big pension funds and other institutional players.

For developers, it would ease both the search for investment and the task of releasing properties.

And for the government, it would ease the upward pressure on house prices whilst simultaneously boosting the construction of new homes, helping to ameliorate the capital's affordability crisis, particularly for vital public sector workers.

In London's ever more pressurised housing market, combining Build to Let with employer nomination agreements could create that very rare creature: a win-win-win-win-win.

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