Reimagine home rental: employer-backed build to rent

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Jan Crosby

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.

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. Schemes to offer 'key worker housing' for public servants have fallen out of favour in recent years[2], and research has found that the average salary of those buying through shared ownership schemes is nearly £44,000[2] – well above the median London salary of £36,000[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. Over the nine years to March 2018, UK house prices leapt by 45% in cash terms[4] but average wages rose by just 17%[5].

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 homes to sell?

So why aren't developers supplying the market need and building in bulk? The explanations many turn to lie in 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 which bids the most for the land wins the deal. They make a bid based on the price they think they can sell the homes at, 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 which 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 and 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, at a particular price, is limited – and also shared with the second-hand supply. If developers over-supply the market, releasing homes more quickly than the rate at which the market can easily absorb them, 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 – both by tempting investment buyers out of the housing market[6], and by improving the ways in which we utilise our current housing stock[7]. We have also 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 £3-5bn[8] 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. BtR investors, on the other hand, 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 five per cent, there is less of a 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 on market rents for employees, while maintaining the price paid to the landowner and preserving the margins for developers. And finding tenants shouldn't be a problem – meaning that signing a nomination agreement is low-risk.

After all, purpose-built properties would have communal areas, cafes, high-quality facilities and fast wifi. 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 and 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.

The PFI connection

Employer-backed Build to Rent could help employers and staff across the public and private sectors – but it has particular strengths when integrated into private finance initiative schemes.

Employer-backed Build to Rent (BtR) is a powerful idea in many contexts. But there are particular opportunities for public bodies as they negotiate second-generation Private Finance Initiative (PFI) deals for the construction and operation of large-scale public service facilities, such as hospitals and secondary schools.

These organisations are signing building management contracts that will stand for decades, committing themselves to operating a large workforce out of their new premises for many years to come. So they can already guarantee to institutional investors that they'll find tenants for long-standing BtR arrangements – minimising investors' risk, and thus costs to the employer. And as public bodies build a financial structure and map out the development of a big new site, it's the perfect time to plan in the resources, partners and land required for a BtR development; they even have an expert facilities management business on site to service the new homes, in the shape of the PFI contractor.

Major schools are also big employers, of course; any decent-sized urban BtR scheme would surely find willing partners amongst the area's other public sector employers, helping to defray the risk for investors. Indeed, those risks aren't much greater for any major public sector investment in service delivery infrastructure – no matter the financial model. But the opportunity to tap into the existing facilities management contract, and the confidence investors would gain from the public body's commitment to a binding, long-term PFI contract – and thus the operation of a large workforce from the site – make BtR a particularly good fit with PFI investments.

Amongst the public sector's PFI projects, it's probably hospitals which would see the greatest benefits – reaching well beyond recruitment and staff morale into service delivery and patient outcomes. Many of a hospital's clinical professionals spend much of their time at home on-call: providing them with homes on-site minimises their travel time and ensures a faster response to medical emergencies. The offer of discounted, convenient housing could also prove particularly powerful in plugging some of the NHS's most acute staffing gaps: hospitals in the South-East, for example, regularly fail to fill over 95% of advertised nursing and midwifery posts[9] – with high housing and travel costs a key obstacle to recruitment. In this environment, providing high-quality, discounted, on-site housing should improve public service delivery for both patients and staff.

And what's the alternative? Constantly sinking more taxpayer-funded London Weighting payments into an overheated market, so that public sector staff can rent an inadequate home miles away from their workplace, their colleagues and their patients? Marrying BtR with PFI could hit the sweet spot for public employers, their staff, taxpayers, investors and patients alike.

Contacts

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