ADDLESHAW GODDARD

BRITAIN'S QUALITY RENTAL MARKET

Build to Rent

FUNDING THE GROWTH OF BTR

Peter Hardy – Partner, Real Estate, at Addleshaw Goddard and

Sarah Egbu – Partner, Real Estate Finance, at Addleshaw Goddard

When Addleshaw Goddard first took an interest in the BTR sector on the back of the Montague Report in 2012, there was fundamentally no interest from investors in institutional investment in the BTR sector. Interest has built slowly, and now many major funds and banks are investing in the sector in a wide variety of ways.

Specific requirements of BTR

BTR as a product has particular requirements and implications that need to be considered by funders, including:

1. location and quality of the building – as BTR tenancies are short term, they are fluid and require very active management;

2. importance of provision of services to the property – there is increasingly a two tier BTR market between high levels of service provision and the more basic, affordable rent, scheme involving repairs and little else;

3. tax implications, particularly around the recoverability of VAT, unlike in office or retail investments.

How is funding being delivered to the BTR sector?

Funding largely comes in two forms – debt for development and investment, and institutional forward funding – with a degree of overlap between the two sources of funds.

In addition to banks, debt providers include Homes England for development, and the government backed Venn Partners scheme for the investment phase. Some will only provide investment phase debt; others only development and a few will provide debt for both phases. Inevitably, given the different levels of risk profile, the terms differ quite radically between development and investment phase loans.

Other institutional investment comes via the forward funding of schemes. This differs from debt products quite markedly as it is designed to buy out the initial developer in its entirety, with no route for the latter to retain an interest in the completed property. However, the nature of the BTR sector and its intensive management requirements mean that the developer, as the ongoing manager under a management contract, can take an interest in the scheme's success via incentivised fees.

Some of the BTR brands are also forward funders, providing finance to buy out a development in the same way as broader institutional funders for whom BTR is just part of their portfolio. They can then specify their detailed requirements to their own standards before delivery, tailoring extra facilities to individual sites.

Where does the money come from and who are the active investors in BTR?

The sources of BTR funding reflects the increasing openness of the UK market to funds from a wide variety of places. Mainstream UK banks get their funding from their usual retail and wholesale sources. The same is true of the UK major funds, although some are looking to leverage their forward fundings, with debt going into the forward funding vehicle, often from offshore sources. European banks (especially German) are beginning to look very closely at this sector.

BTR providers who have built themselves up from the ground – such as Essential Living, Moda Living and Fizzy Living – have US and Middle Eastern money behind them. However, the big UK property companies are looking to access this market, if reports that British Land is pursuing Fizzy Living come to fruition. If this happens, they will probably use their normal sources of finance to develop further in the sector. Other long term residential specialists like Grainger and the housing associations (Thames Valley Housing Association set up Fizzy, and Places for People has invested heavily) are obviously active in this sector, as a natural extension of their existing businesses. The ability of housing associations to tap up the bond markets could be a real boon for them in developing BTR products.

Many of the large UK funds have a presence, and those that do not are thinking about it carefully. L&G and M&G are prominent, as is Aberdeen Standard. Hermes has joint ventured with Countrywide to get into the market, and Aviva says it is keen to enter too. These funds largely use their long income funds to set off annuity liabilities, tying into the benefit of a residential income and capital return, which have historically outperformed other markets. Many have owned similar assets in the past, and are having to re-learn the necessary skills. Funds normally outsource management responsibility to independent providers, although they may bring management in-house as they increase both their portfolios and their confidence in managing these assets.

Other large non-UK funds are beginning to enter the market, including Greystar, Realstar and Cortland. They have experience of the huge multi-family market in the USA, the source of much of the thinking for PRS in this

country. Whilst the USA is a very different place, where land is plentiful and relatively cheap outside the main city centres, some of the concepts will be transferrable, aiding their progress in the UK markets.

Finally, we are beginning to see the development of the use of REITs as tax efficient structures for the delivery of PRS funding. The first movers in this have been Sigma and Grainger with their respective PRS REIT and GRIP vehicles, and more long term non-institutional holders of BTR stock may join them.

Banks in the market

At the time of our original report, the big four UK banks were venturing tentatively into the BTR sector. It is now a hot topic for the majority of banks operating in UK commercial real estate, and for the debt funds that have entered the market in recent years. Those not already in the BTR sector are looking to enter it.

Bank funding into the BTR sector started, and has remained, at the development through to investment/stabilisation of asset stage, including providing development funding to the equity forward funders. The influx of banks into the sector has made for a competitive field. The German lenders, including Deutsche Pfandbriefbank, Deutsche Bank and Helaba, have established their positions in the UK BTR market. Wells Fargo has funded a number of UK schemes, including the original development of what is now Lonestar and Quintain's Wembley scheme (with AIG and CPPIB). Irish banks, Bank of Ireland and AIB, have also entered the sector and are looking to make their mark (the latter having made its foray into the sector with a £50m participation in a Grainger development facility).

The regulatory capital requirements applicable to banks play into short-medium term lending, so providing development funding flipping to investment funding for the asset stabilisation period is the current sweet spot for banks. Four to seven year funding is common. The low yielding, long term nature of the operational assets, however, suits capital markets and institutional funds more than banks. The government backed Venn scheme, which provided up to 30 year money against stabilised assets up to 80% and has been the main source of funding for the investment/stabilised asset phase, came to an end in December 2018; what, if anything, will replace it, is currently being debated. Whilst there is plenty of long dated liquidity in the market, leverage models for the sources of that long dated liquidity are challenging when taking out bank funding.

Banks are looking for ways to be able to fund these low yielding long term operational BTR assets without having to fund over longer periods than their cost of capital can justify. Perhaps with an ever increasing number of stabilised assets in the market and beginning to change hands, a market for shorter term investment lending will emerge, and some of the historic challenges around limited data on the marketability and operational costs of BTR assets will be overcome, easing the way for bank liquidity to enter into the operational phase of BTR assets.

addleshawgoddard.com

Aberdeen, Doha, Dubai, Edinburgh, Glasgow, Hong Kong, Leeds, London, Manchester, Muscat, Singapore and Tokyo*

* a formal alliance with Hashidate Law Office

© 2019 Addleshaw Goddard LLP. All rights reserved. Extracts may be copied with prior permission and provided their source is acknowledged. This document is for general information only. It is not legal advice and should not be acted or relied on as being so, accordingly Addleshaw Goddard disclaims any responsibility. It does not create a solicitor-client relationship between Addleshaw Goddard and any other person. Legal advice should be taken before applying any information in this document to any facts and circumstances. Addleshaw Goddard is an international legal practice carried on by Addleshaw Goddard LLP (a limited liability partnership registered in England & Wales and authorised and regulated by the Solicitors Regulation Authority and the Law Society of Scotland) and its affiliated undertakings. Addleshaw Goddard operates in the Dubai International Financial Centre through Addleshaw Goddard (Middle East) LLP (registered with and regulated by the DFSA), in the Qatar Financial Centre through Addleshaw Goddard (GCC) LLP (licensed by the QFCA), in Oman through Addleshaw Goddard (Middle East) LLP in association with Nasser Al Habsi & Saif Al Mamari Law Firm (licensed by the Oman Ministry of Justice) and in Hong Kong, Addleshaw Goddard (Hong Kong) LLP, a Hong Kong limited liability partnership pursuant to the Legal Practitioners Ordinance and regulated by the Law Society of Hong Kong. In Tokyo, legal services are offered through Addleshaw Goddard's formal alliance with Hashidate Law Office. A list of members/principals for each firm will be provided upon request. The term partner refers to any individual who is a member of any Addleshaw Goddard entity or association or an employee or consultant with equivalent standing and qualifications. If you prefer not to receive promotional material from us, please email us at unsubscribe@addleshawgoddard.com. For further information please consult our website www.addleshawgoddard.com or www.aglaw.com.

REF: 12324