# Funds offer wannabe landlords an alternative

Created:
2 October 2009
Updated:
14 October 2009
Written by:
Faith Glasgow

Since the beginning of the year and even before, cool-headed professional investors have been slipping quietly back into the UK's battered residential property market to pick through the wreckage of distressed re-sales and deals from desperate developers. Now, as the monthly house price statistics finally indicate that the market appears to have troughed, private investors are starting to look with renewed interest at the potential for getting in at the bottom - and a rash of retail funds has been launched to cater for their needs.

The fundamentals are certainly interesting. According to Land Registry figures, average prices in England and Wales had fallen 17 per cent from their high point around November 2007 to April this year, since when there has been a small recovery. But prices are still down more than 15 per cent on the peak.

However, Richard Donnell, director of research at market analyst Hometrack - which reported a marginal price upturn in August - makes the point that the 'green shoots of recovery' are so far limited to just a fraction of England and Wales. "The results of our latest survey show that far from being a national housing market on the up, the headline figures are being skewed by price rises that are restricted to relatively small pockets of the market suffering from a lack of housing for sale, primarily in London and the south east," he says. Elsewhere, the market is pretty much static.

At Savills, head of residential investment Natasha Ham says that on top of the market fall, sellers making forced sales of portfolios and builders wanting to get shot of stock are having to accept discounts of 20 to 25 per cent to current valuations. "The difficulty is in matching up the expectations of investors with those of some vendors - we've looked at banks' repossession portfolios in the last couple of months, but many don't want to make deals at that level of discount."

She also warns that some commentators anticipate a further dip before any real recovery sets in. "There's a perception that the market may not have quite bottomed out yet, and there's likely to be only limited growth over the next two years; but there is nonetheless a feeling that this is the window of opportunity for residential funds."

An additional 'big picture' factor likely to put more upward pressure on house prices over the long term is the fall-off in new developments as a result of the credit crisis. A recent report in the Architects Journal , for example, suggested there could be a new-build shortfall of up to 750,000 units in the UK by 2016. Average house prices could be around 20 per cent higher than present levels by 2014, according to the National Housing Federation.

For Stuart Law, managing director of property consultancy Assetz, the present situation is an outstanding investment opening. "In the 10 years this company has been running, I've not seen a bigger dichotomy between the [low] prices being asked by people who must sell and the [also low] levels of demand out there. There has also been a big change in the investment market since the beginning of the year, with a really substantial number of high-quality investors with cash - many of whom have never held residential property before - taking the view that bricks and mortar are now a very good investment."

However, he adds, only around 10 per cent are opting for direct ownership in the shape of buy-to-let. "The vast majority would rather go indirectly - they don't want the hassle of finding suitable properties and being a landlord."

There are several other big pluses as far as investment via a collective fund is concerned. First, although these funds are only available to 'sophisticated investors' through financial advisers, and require a

minimum investment in most cases of around £20,000 to £25,000, they provide access to a portfolio of properties. For relatively cautious investors, that's vastly preferable to tying up large sums of money in a single, illiquid asset.

Second, at a time when buy-to-let investors may be deterred by the difficulties of finding a large enough mortgage deposit, funds offer geared exposure without having to go down that route at all. And third, unlike direct property holdings, residential property fund investments can be bought and held tax-efficiently as part of a *self-invested personal pension* (Sipp).

**What's on offer**

One or two early-bird funds - for example, Finchatton's three-year central London offering, which closed in July - were launched earlier in the year to take full advantage of the opportunities for distressed purchases; and several more have joined them in recent weeks. There are some common features: these are closed-ended funds likely to run for around five years, and planning to enhance their investment prospects with gearing of around 50 per cent.

But closer inspection reveals that there is less overlap than might perhaps be expected in their geographical focus, risk profiles and general investment strategies. In other words, if you are interested in getting into the market through this route, look carefully at the various options because they do differ from each other.

A couple are London-focused, but even they have taken markedly different tacks.

The specialist consultancy London Central Portfolio (LCP) will invest in its core area of prime central London for its Recovery fund; £5m of the £10m equity target has been raised already and the plan is to close the fund to new investors by the end of the year.

"The portfolio will consist of the kind of properties we select for our private clients: one- and two-bedroom flats in Belgravia, Knightsbridge and Chelsea, where we can add value with an extra bedroom or bathroom at the outset," says manager Hugh Best. The properties are rented almost entirely to international professional tenants - who are most likely to be in a position to pay the £500 or so per week asked on a one bedroom apartment or £1,000 a week for a two-bedroom unit.

The target is an annual internal rate of return (IRR) of 15 per cent (including the value added through refurbishment, capital growth and rental yield). An added attraction for investors - providing interest rates stay low - is that the 55 per cent gearing will be funded at an exceptionally low rate of 1 per cent over base rate. "The original financial calculations for the fund were based on borrowing at 6 per cent, so this deal will provide investors with an extra cash cushion," says Mr Best.

South-west London boroughs are the target of property consultancy Walls & Futures' London Growth fund. "We're looking at a mix of studios, apartments and houses in established areas such as Fulham, Chelsea and Hammersmith, that have suffered in the slump, but also at slightly more distant, up-and-coming districts like Southfields," says managing director Joe McTaggart. "The focus is very much on middle-market tenants."

Again, the aim is to hunt down "the worst house on the best street", add value through upgrading at the outset and rent out to the area's burgeoning population of prosperous young professionals. Mr McTaggart emphasises that the 50 per cent gearing is based on a 'non recourse' loan, which basically means that if the market collapsed again and the fund was unable to meet its liabilities, investors would not lose more than their initial investment; the bank could not chase them for any shortfall on the loan, as can happen with conventional mortgage lending.

The target return of 10.5 per cent a year assumes prices will rise by an annual average of 5 per cent, although Mr McTaggart believes that's a pretty conservative estimate, given the capital's worsening housing shortfall. The Greater London Authority estimates that London could face a shortage of 60,000 homes by 2012 - which, Mr McTaggart says: "could see London property prices rising sharply over the next five years".

Other funds take a broader view of the UK market. The Residential Property Recovery fund was launched in July to invest in distressed and mispriced homes in the Midlands and northern England, and is set to close by the end of October. The fund concentrates particularly on regeneration areas where public and private investment is being channelled; such areas, research suggests, tend to outperform when house prices are rising.

Director Barney Buik reports he is now sourcing stock at 50 per cent of its 2007 peaks. "There are units that sold for £140,000 in 2007; we are now paying £65,000 - £70,000 for the same product" he says.

Assetz's latest residential fund, just launched, will hold purely distressed acquisitions, both new-build and resales. "The market in the south east and London has already strengthened and the discounts available from forced sellers have largely evaporated, so in those areas we are looking only at bank repossessions and the occasional developer who will do a deal," says Mr Law.

"But in other parts of the country the recovery has not started, and developers are having to do deals of 25 to 35 per cent off the current valuations. We're working on some very high-quality schemes in locations such as the centre of Manchester and Liverpool waterfront, at 50 per cent off their 2007 prices."

The properties will be tenanted, but the fund places little emphasis on rental yield. Nor does Mr Law make any significant assumptions about wider house price growth over the five-year term: "If prices go up by 2-4 per cent a year we'll meet the target," he says. Instead, most of the target annual return of 15 per cent plus will come from growth on the heavily discounted purchase prices. "We will sell stock and turn over the portfolio as we go; it's possible to get a substantial uplift in six to 12 months and sell on, which has been working very well for us."

Another newcomer investing across the UK is the open-ended Luxembourg-domiciled fund from Garratt Property Group, which requires a minimum £20,000 and forecasts a 70-100 per cent return over the fund's five-year life.

So the choices are there, and there are likely to be more opportunities appearing on the market in the coming months. On the grounds that the current investment bargains will not be around for ever, however, there's an argument for acting sooner rather than later. As Mr Best of London Central Portfolio says: "We think prices have bottomed out and are now starting to tick upwards; liquidity is easing, and investors will start to come back from here on, but we want to be there before them - we aim to be fully invested before the spring market really picks up."

**Brazil: A bricks and mortar opportunity**

With its economy estimated to grow 5 per cent in 2010, a youthful and expanding population, a housing shortfall of around 1m and government-backed mortgages for developers and homebuyers, Brazil's residential property market is another interesting proposition, albeit for very different reasons.

One enterprising British fund manager has set up a UK fund to "share in the developer profits from a number of local real estate developments" in the prosperous (oil-rich) state of Sergipe in north-eastern Brazil. The projects lined up in the capital, Aracaju, are focusing on strong local demand for housing, not tourism.

Investors in the Sippable three-year 4:Property Hypa Investments fund will need an adventurous streak and a minimum of £20,000; but they are promised an expected IRR in excess of 25 per cent a year from the sale of the new homes. As a safeguard, no performance fee is earned by the manager until investors have received their first 12 per cent each year. The fund manager is Financial Services Authority regulated, and is available only through *independent financial advisers* (IFAs).