# Research Blast

UK Real Estate Market, April 2016

## Continued rise in stamp duty taxes runs the risk of damaging future investment in UK real estate

It feels like a long time since George Osborne delivered a budget without some form of significant change to the tax structure on UK property investment. While the sector has undoubtedly performed well in recent years, and may be seen as an easy target to generate some additional income for the Treasury, there are inherent risks attached with making the UK a less attractive and viable investment proposition to institutional investors. Over the long term, should the rise in tax damage the reputation of the UK as a country where investors can operate within a stable fiscal environment, then the potential loss of investment, particularly from overseas buyers, may cause far more long-term damage than it creates in raising short-term revenues.

**Residential market**

In the summer 2015 budget it was announced that in an attempt to dampen the buy-to-let market, the tax relief which enables landlords to offset their mortgage interest against rental income would be phased out from 2017 onwards. Companies, however, were exempt and subsequently a large number of private landlords registered their property portfolios as limited companies to avoid the change in regulation.

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In the autumn spending review buy-to-let investors were dealt a further blow when it was announced that all buy-to-let purchases would be subject to an additional 3% stamp duty on each tax band. On this occasion the change in legislation was to include all investors; however, a potential exemption was included for larger companies with the capacity to deliver additional homes through investment in existing stock and development of new builds. Given the shortage of homes being built in the UK it was somewhat surprising that this concession was scrapped in the 2016 budget:

*"Following consultation, the government has decided…there will be no exemption from the higher rates for significant investors, and the higher rates will apply equally to purchases by individuals and corporate investors" – 3.20 Additional Properties, 2016 UK Budget.*

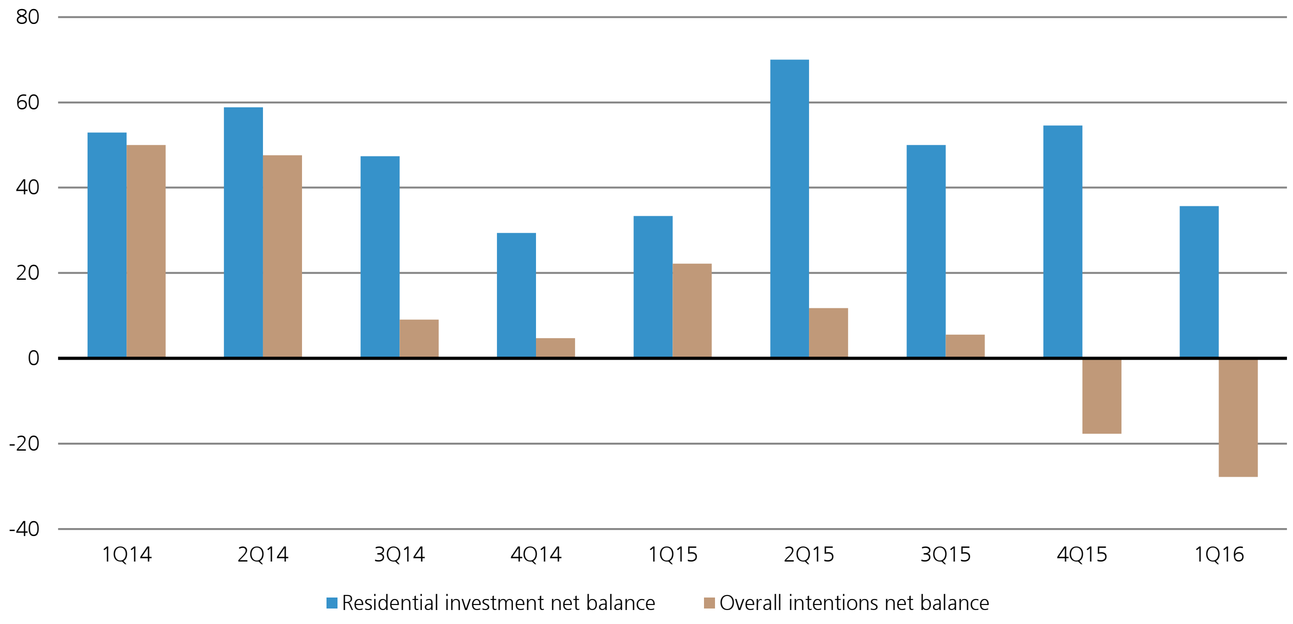
The UK has traditionally had a build-and-sell residential property development sector, with the private rented sector primarily made up of small private investors. Institutional property investment funds were generally focused on traditional commercial property (retail, office and industrial). This has been changing recently; however, and institutional investors have been showing increasing interest and demand for the "alternatives sector" which includes property such as hotels, student accommodation and leisure. Investment into the alternatives sector rose to a new record level in 2015 at GBP 17.8 billion, accounting for 39% of the total volume invested.

The Private Rented Sector (PRS) was also starting to gain some traction as another alternative investment sector for UK real estate funds. The concept of PRS amongst institutions is already well established in the US and in European countries such as Germany, the Netherlands and Sweden. The strong drive within the UK for home ownership and the need for the major home builders to recuperate capital with which to fund the next scheme means this sector currently has comparatively few institutional-grade residential schemes developed purely for the purpose of rental.

However, given the very positive demographics in the UK (particularly in major cities) where the presence of a large, professional foreign workforce generally preferring to rent rather than buy, combined with the success of similar schemes in other developed countries and a lack of existing stock, meant that the proposition had attracted the interest of institutional investors. According to PMA's latest UK investor intentions survey (taken before the stamp duty changes), while overall investment intentions have turned negative in recent quarters, intentions for residential investment have remained in a strong positive position.

**Survey of UK investor intentions – do you intend to invest more or less in the next 12 months?**

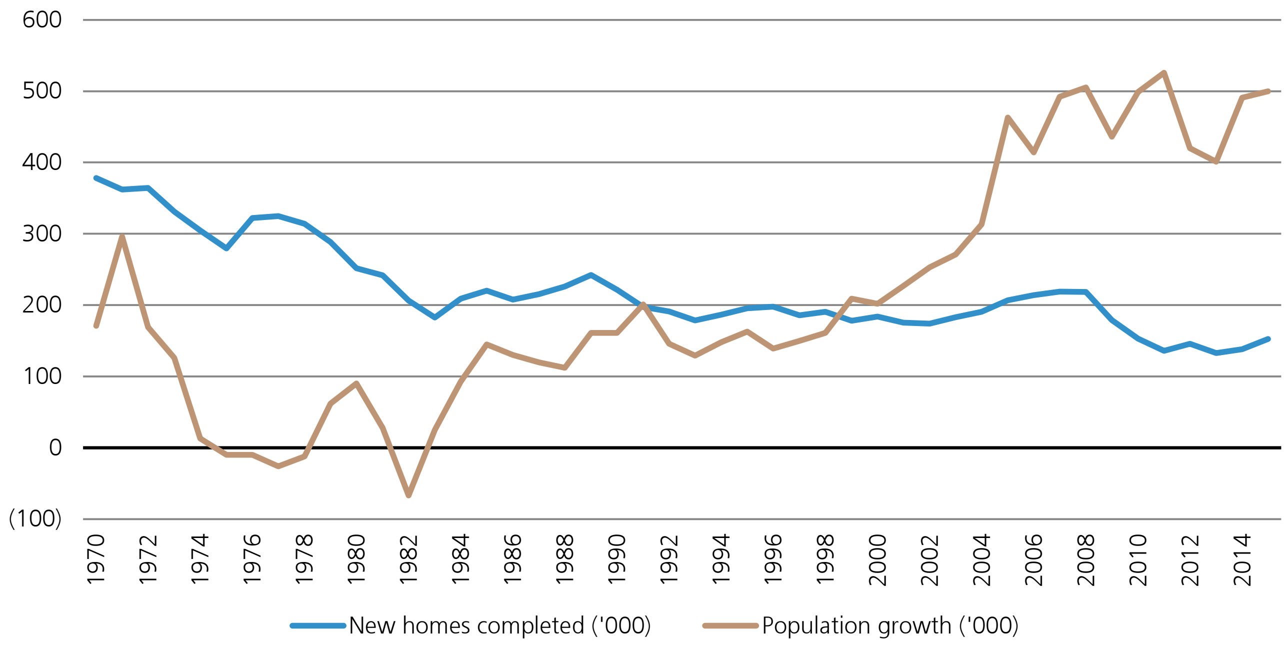
(net balance of responses)




Source: PMA UK Survey of Investor Intentions 1Q16

The UK is struggling with a housing shortage and with the urban population continuing to grow, further housing developments are required to keep pace with demand. The mismatch is most pronounced in London, where the population is forecast to increase at an average annual pace of 125,000 people per year between 2015 and 2020, bringing the total population to 9.4 million. It is estimated that 50,000 homes per year need to be built just to keep pace with demand. Despite the annual level of residential units completing in London increasing by 35% in 2015, the total for the year reached just 24,260 homes, half the required level. And with the number of building starts in 2015 totaling a similar level (24,320), the level of new homes being delivered to the market is set to remain 50% below the required level to balance demand.

**UK housing building is in decline while population growth has accelerated**




Source: ONS, Department for communities and local government

As there is very little existing purpose-built rental stock for institutional investment, were large scale property funds to enter the PRS sector in the UK it would have to come through development of new schemes. Engaging with institutional investors could stimulate investment and development activity, leading to an increase in the number of new homes being delivered. However, residential development in the UK is expensive, particularly in London and the south east, and after taking into account management costs, void costs, development risk and various other factors, the margins on the sector are relatively tight. Considering the need for a degree of risk premium when entering into a non-traditional asset class, by putting an additional 3% charge on buying the property many investors who were seriously considering PRS may be pushed away from the idea.

One of the largest downside risks for institutions to enter into the residential sector is the scope for governments to intervene to such an extent that the expectations of returns can completely shift. It will be of particular concern that in the Conservative government's manifesto written before the May 2015 election, there was not a single mention of increasing stamp duty should the party be elected. This would suggest that the government is prepared to intervene in the property sector in an ad hoc manner, taking knee-jerk decisions to raise taxes which are likely to damage the UK's reputation as a stable fiscal environment to invest in, and weaken government credibility, particularly to overseas investors.

**Commercial**

In addition to making entry into the residential market a less attractive proposition for institutional investors, George Osborne delivered another blow within the traditional asset classes. In the 2016 budget the chancellor introduced a new slab system of stamp duty tax on commercial purchases, with investors now paying 0% on the value of their purchase up to GBP 150,000, 2% between GBP 150,001-250,000 and 5% on GBP 250,001 upwards. Under the previous system, investors had paid a set percentage on the whole purchase cost depending on the value of the transaction, with any purchase over GBP 250,000 incurring 4% stamp duty. This will make purchases up to GBP 1.05 million cheaper than previously and everything above that threshold more expensive. However the vast majority of commercial property transactions to investors are for assets of (significantly) larger than GBP 1.05 million. In 2015 the average value of a commercial property transaction reported on property data was GBP 25 million, which under the new system would incur stamp duty tax of GBP 125,750 compared to GBP 100,000 under the previous system.

The UK commercial property market has established itself as one of the most desirable locations for foreign investment, and in recent years it has proved particularly popular with investors from the Middle East and China. Capital invested into the market from these regions totalled GBP 12 billion in 2015, compared to just GBP 3.6 billion a decade earlier. An increase in capital available for investment coupled with deregulation allowing money to be invested outside of the domestic region has been a key driver of this changing dynamic. While this has resulted in an increase in global activity, the UK market and in particular London, remains far and above the location of choice. To put it in context, in 2015 London attracted more capital from foreign buyers than the next six largest European markets combined.

Reasons frequently cited for this preference for UK real estate have included a favourable tax regime, a strong legal framework and relatively political and economic stability. However, with a referendum on EU membership approaching, the changes in stamp duty tax come at a time when foreign investors have already become notably more cautious towards investing in the UK. Large-scale investment from foreign buyers does not only generate significant tax revenues for the treasury, but has the potential to deliver capital to drive forward key schemes across the UK. In the current environment of heightened political uncertainty and rising taxes on property transactions, this flow of capital is likely to be disrupted with potential negative consequences for the development of new schemes. And it is important to note that the foreign capital entering the UK market does not just benefit the Treasury through direct stamp duty taxation, but feeds through into all the various indirect revenue streams such as agent fees, legal costs, asset management fees, construction contracts etc., which create further revenue to the treasury through VAT, corporation tax and income tax and supports the property industry in the local economies where the investment is made.

**Summary**

The UK government has identified the property market as a sector to generate additional income to attempt to achieve a budget surplus by 2020. And at the same time the increase in taxes levied against buy-to-let landlords are being justified as necessary action to cool the market and discourage investors from buying UK homes. But this misses the fundamental point that a housing crisis exists, not because there are too many buy-to-let investors but because there is not enough housing developments to keep pace with demand, which has in turn inflated house prices. Indeed, this has been the dominant theme of Conservative policy towards the UK housing shortage. Rather than addressing supply side issues, they have introduced fiscal measures to try and boost affordability for first time buyers with schemes such as "help to buy" and the "help to buy ISA". But this can be counterproductive as it only serves to boost the demand side without supporting additional supply, leading to house price inflation. And while they remain reluctant to make decisions which could unlock the necessary land and ease planning constraints, particularly in London and the south east, it is difficult to see the balance between the demand and supply of homes in the UK changing despite the introduction of the new stamp duty taxes.

A viable option to help boost the supply side would have been to engage with the institutional investors who were showing clear interest in entering into PRS development on a large scale. But rather than engage with these investors, the chancellor has introduced tax reforms which makes the UK real estate market as a whole a less appealing investment destination. While there may be short-term financial gains for the treasury the long-term consequences of taking them could ultimately have far reaching negative consequences.

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