Lessons for investing in student accommodation

Investment Simon Rutman explains why student accommodation continues to attract investment and looks at some of the issues that investors and developers need to consider

McLaren Property's proposed student housing scheme in Greenwich

In 2007 and 2008, as recession loomed and developers and investors reduced their exposure to mainstream property ventures, student housing became a popular investment. That first wave of development has now come on-stream and, with continuing strong returns, investors are still seeking opportunities in this sector.

Why invest in the student sector?

The main reasons for the continuing investment appeal of student accommodation include:

- Traditional lenders are still more risk-averse than six years ago, so there are good opportunities for more entrepreneurial lenders.
- When combined with exclusivity agreements with universities, investments in student blocks offer long-term income streams.
- Student numbers are holding up despite increased fees, partly due to a rise in the number of overseas students.
- Despite the high levels of private equity investment in the sector over the past five years, there is still a lack of good quality accommodation in the prime spots.
- Commentators argue that the recent trend for increased global student mobility is set to continue and that London and other prime UK university towns are well placed to benefit from it.

Tuition fees and demographic trends

Since Parliament voted in 2010 to allow universities to increase tuition fees to £9,000 pa from September 2012, market analysts have warned that student numbers would fall dramatically and that this would have negative effects on occupancy levels, rental returns and capital values of student halls.

In practice, however, the decrease in domestic students was much less significant than feared. In part, this decrease was thought to be due to the bulge year in 2011 as people rushed to take up places before the higher fees were applicable.

The second factor is the downward demographic trend in total numbers of 18-20-year-olds in the UK. According to the projections published by the Office for National Statistics in October 2011, the population of 18-year-olds is due to fall from 808,000 in 2010 to 689,000 in 2020.

Will this forecasted demographic change damage the student housing sector in the mid to long term? It is thought not, on the basis that any deficit in domestic students will be compensated for by increased numbers of overseas students. Their overall numbers held steady in 2012, with the proportion of EC students dwindling slightly but non-European students increasing in number. This is welcome news for investors and developers as this group tend to prefer purpose-built blocks and is often prepared to pay higher rents than other groups.

Planning

The planning categorisation of student halls depends on the sort of building in question, the number of occupiers and the identity of the owner/manager of the property. Class C3 is intended for accommodation occupied by six or fewer people forming a single household with or without the provision of care for the residents. Where more than six unrelated people share a house, the planning use is classified as *sui generis* and cannot be changed without planning consent.

Class C4 is for use as a house in multiple occupation (HMO). For planning purposes an HMO is a house which is occupied by between three and six unrelated occupants as their main residence, sharing basic amenities. However, there are various uses excluded from this use class, including properties occupied by students and managed by the educational establishment that they attend.

A slightly different definition of an HMO exists for licensing purposes, contained in section 254 of the Housing Act 2004:

- a house, flat or converted building that is let to three or more tenants, who form two or more households and share facilities such as a kitchen, bathroom or toilet; or
- a building converted into self-contained flats where the conversion did not meet the standards of the Building Regulations 1991 and less than two-thirds of the flats are owner occupied.

It is a criminal offence to manage or control an HMO that should be licensed but is not. However, certain types of buildings are exempt from the definition of an HMO, including one occupied by students and managed by their educational provider.

Planning guidance

The mayor of London published his *Housing Supplementary Planning Guidance* in November 2012. It recognises the need to cater for various groups, including students, but also expresses

WHAT ACCOMMODATION MAKES THE HIGHEST RETURNS?

- Central London is the prime location for student halls. Total return for purpose-built student property grew 6.7% between September 2010 and September 2011, according to Knight Frank's report *Student Property 2012*.
- In London the most popular rental level is around £220 per week.
- Outside London the best locations are those near to the highest-rated universities. Rents are lower and increase at a slower rate, but still went up by 4% on 2010/11, according to Knight Frank.
- Purpose-built blocks of more than 100 beds paces are the developer's or investor's preferred product because of economies of scale at the construction phase and efficiency and extra profit opportunities at the management phase (see box, right).

concern that the burgeoning development in this sector threatens other parts of the housing market. He plans to investigate how to:

> "disperse student accommodation away from areas in and around central London to locations which are conveniently accessible for students, which can offer competitive alternative provision and which can contribute to local economies."

Analysts warn that if this suggestion does result in policy it might then have a negative impact on future student development because viability is more marginal outside core locations. However, any future change in this direction would not necessarily affect the viability of existing student housing. If it becomes harder to obtain the necessary planning consents, this might increase the value of existing investments.

Tenancy Deposit Scheme (TDS)

The student and the landlord or manager will usually enter into an assured shorthold tenancy agreement. Since 6 April 2007, it has been mandatory for a landlord to join a TDS on creation of such a tenancy in England or Wales if the tenant pays a deposit. The landlord can choose between a custodial TDS (which requires the landlord to pay the deposit to a scheme administrator within 30 days of receipt) and an insurance TDS (under which the landlord keeps hold of the deposit but secures it by paying a fee and insurance premium to the scheme administrator).

Compliance involves a certain amount of administrative effort, but can be used as a marketing benefit as students are increasingly aware of this obligation and wary of landlords' historic practices regarding deposits.

Ownership and investment structures

As investment financing of student halls has increased, a range of structures has emerged:

- Sometimes a university buys or already owns a suitable plot of land and enters into joint venture agreements with developers, often involving long-term leases plus nomination agreements to guarantee occupancy rates.
- Alternatively, universities may be keen to offload maintenance responsibilities for old blocks and therefore sell all their halls to developers in a stock transfer arrangement. The university typically takes a lease back and agrees to ensure that there are no voids.
- Investment funds sometimes contract with or own operators such as Unite, Nido and iQ, which run the blocks in a similar way to hotel operators.

PURPOSE-BUILT BLOCKS

Professional operators of purpose-built student accommodation blocks often:

- market their product with glossy websites advertising a range of flats, from studios to rooms in a cluster of six or seven rooms sharing living quarters;
- designate social hubs in the blocks with cable TV and organised social events;
- offer a range of add-ons, such as gym membership, laundry services, car parking, extra storage, and hire of linen;
- advertise various benefits over traditional student houses, including flexible lengths of stay, all-inclusive rents including contents insurance, and on-site maintenance assistance;
- emphasise their appeal to overseas students due to their perceived security, central locations and the certainty offered by all-inclusive charges; and
- enter into exclusivity agreements with universities which know that access to high-quality accommodation will act as a draw to overseas students.

VAT

The key VAT issue for developers and investors will be to prevent irrecoverable VAT arising on construction costs. Care is needed since the eventual supplies of the accommodation to students will be exempt for VAT purposes and any VAT incurred that is treated as attributable to those supplies will not be recoverable.

If the construction phase is carried out in the ownership of a developer before the building is sold or long-leased to its eventual operator, the sale or long lease can often be treated as zero-rated for VAT purposes, enabling recovery of construction costs. Alternatively, if the construction phase is carried out in the ownership of the eventual operator, it will often be possible for the operator to certify to its contractors that it intends to use the building for a "relevant residential purpose" which enables the contractors to zero-rate their supplies.

However, in either case, great care must be taken if there is any intention to exploit the buildings otherwise than by letting them to students (for instance, letting rooms to the public during holidays). With either of the structures described above, arrangements of this type can lead to zero rating being unavailable, with the consequence that irrecoverable VAT will arise. Any future sale or change in use of all or part of the building should be carefully analysed to prevent a VAT cost arising.

Finally, care is needed in relation to fit-out works as there are a number of provisions that limit the recovery of VAT incurred, even if as a general matter construction-related VAT is being recovered successfully.

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