2018: Trends in the purpose built student accommodation sector

Generating opportunities in a challenging and competitive market

TaylorWessing
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Introduction

2017 was another strong year for the UK purpose built student accommodation (PBSA) sector, with the cumulative value of investment totalling £4.07bn, close to £1bn higher than the previous year and climbing back towards the record level seen in 2015.

Knight Frank’s student property team estimates that the value of the UK PBSA sector will hit £50bn by 2019.

In this year’s trends report, the Taylor Wessing student accommodation team consider the continuing attractiveness of the sector to global investors. We evaluate some of the challenges faced by different stakeholders that may impact on decision making processes and further growth and look at where the future opportunities might be for developers, investors and operators.
What’s going on in the market?

The cumulative value of investment in 2017 was £4.07bn, close to £1bn higher than the previous year and climbing back towards the record level seen in 2015. This was underpinned by the investment strategies of some of the key players to consolidate and increase market share.

Two significant portfolio deals that completed in December 2017 (iQ Student Accommodation’s acquisition of the Regent Portfolio for £869m and Arlington Property Investors’ acquisition of the Study Inn Portfolio for £135m) brought to a close another resilient year for the sector. Other significant transactions in 2017 included acquisitions by Brookfield, CPPIB, Unite, GCP Capital, Europa & Generation Estates and Tristan Capital.

Q1 2018 showed signs of a further year of consolidation in the sector, with Brookfield completing its acquisition of the Enigma Portfolio for £520m and total investment in the quarter estimated to have exceeded £1bn. In June 2018, Property Week reported that Round Hill is understood to be in exclusive talks with Watkin Jones to forward fund seven PBSA developments with a GDV of £250m.

<table>
<thead>
<tr>
<th>Year</th>
<th>Value (bn)</th>
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<tbody>
<tr>
<td>2014</td>
<td>£1.5bn</td>
</tr>
<tr>
<td>2015</td>
<td>£5.1bn</td>
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<tr>
<td>2016</td>
<td>£3.1bn</td>
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<tr>
<td>2017</td>
<td>£4.07bn</td>
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<tr>
<td>2018*</td>
<td>£4.5bn</td>
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</tbody>
</table>

*Projected

Source: Knight Frank (May 2018)
Two further large portfolios of existing stock are also being marketed for sale. A number of new joint ventures and funds have been announced and new global investors are actively seeking out opportunities to take a stake in the sector. All signs point to another strong year.

Knight Frank’s Student Property Team estimates that the cumulative value of investment transactions in 2018 will be around £4.5bn and that the value of the UK PBSA sector will hit £50bn by 2019.

In our view, the fundamental characteristics and drivers that have attracted increasing global investment into the asset class over the last 5 years (the supply/demand dynamic, stability and resilience to economic downturns, relatively low risk of tenant default and the reputation of UK academic institutions, amongst others) remain compelling and will continue to drive future growth of the sector.

We anticipate that there will be fewer portfolios changing hands in 2018 but a steady stream of high value single asset deals as market leaders continue to consolidate their portfolios and grow their brands. We also envisage further acquisitions of equity stakes in established investment and operating platforms and greater collaboration with universities to revitalise some of the more tired stock.
Reputation and demand

Whilst we cannot ignore the press coverage on the potentially adverse impact that Brexit will have on the quality and demand for UK higher education, is that anything more than political rhetoric? We have yet to see any real evidence of a downturn in global demand.

The major UK universities continue to score well in the reputation rankings (the current list of the best universities in the world published by Times Higher Education is led by two UK universities for the first time) and the latest UCAS figures indicate that demand for places remains strong.

World University Rankings 2018 (UK entrants)

<table>
<thead>
<tr>
<th>Rank</th>
<th>University</th>
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<tbody>
<tr>
<td>1</td>
<td>University of Oxford</td>
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<tr>
<td>2</td>
<td>University of Cambridge</td>
</tr>
<tr>
<td>8</td>
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</tr>
<tr>
<td>16</td>
<td>UCL</td>
</tr>
<tr>
<td>=25</td>
<td>London School of Economics and Political Science</td>
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<tr>
<td>=27</td>
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<td>University of Glasgow</td>
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<td>University of Warwick</td>
</tr>
<tr>
<td>97</td>
<td>Durham University</td>
</tr>
</tbody>
</table>

Source: The Times Higher Education World University Rankings 2018
The chase for viable prime development sites continues

Against that backdrop of buoyant investment appetite and strong demand, developers continue to seek out opportunities to bring forward new schemes in the right locations. However, planning policy, high community infrastructure levies, rising construction costs and the impact of competing land uses on the availability of land (amongst other constraints on the development pipeline) have created a challenging environment to navigate.

The spotlight on affordability continues to present a challenge to the viability of new PBSA schemes. The Supplementary Planning Guidance issued by the Mayor of London in March 2016 requires new development of PBSA to include an element of provision that is affordable for students. We considered the 2016 Guidance in detail in our 2017 Trends Report. It requires the element of affordable PBSA to be the “maximum reasonable amount subject to viability” and the annual rental cost for the affordable PBSA not to exceed a figure published by the Mayor in his Annual Monitoring Report (AMR). For the 2017-18 academic year the annual rental cost for affordable PBSA must not exceed £6,051 which equates to a weekly rent of £159 for a 38-week contract. The next AMR will be published in July 2018.

However, the 2016 Guidance specifically excludes from the requirement PBSA developments where the provider has a nominations agreement with one or more academic institutions that specifies that the accommodation will be occupied by students of the relevant institutions and where the continuance of the agreements for as long as the local authority considers appropriate is secured by a planning condition or agreement.
The draft new London Plan issued by the Mayor in December 2017 and setting out a policy takes the affordability requirements a step further. Draft Policy H17 (see page 8) requires that all PBSA “must either be operated directly by a higher education institution or the development must have an undertaking in place from initial occupation, to provide housing for students at one or more specified higher education institutions, for as long as the development is used for student accommodation”.

A majority of the bedrooms in the development must be covered by such an undertaking. If the PBSA is not secured for use by students and for occupation by one or more specified higher education institutions, it will not be considered PBSA or meeting a need for PBSA and the development proposal will be considered large-scale purpose-built shared living and assessed by the requirements of Policy H18.

Further, the draft Policy H17 requires 35% of student bedrooms in all new PBSA to be affordable. If that threshold is not met, a scheme will be considered under the viability tested route in line with part E of Policy H6 and the Mayor’s Affordable Housing and Viability SPG. This application of the affordable housing threshold to all PBSA marks a shift in approach to the current London Plan which only seeks affordable housing where there is no nominations agreement in place.
In its response to the consultation on the draft new London Plan, the British Property Federation (BPF) has raised a number of concerns and suggestions for further review. These include:

- a concern that requiring a link to a higher education institution will limit access to PBSA for students of smaller institutions and put more pressure on the conventional residential housing stock
- the lack of clarity in the draft policy as to what constitutes a nominations agreement, the length of term required and the percentage of beds within a scheme that would constitute an “undertaking” – higher education institutions may be reluctant to contractually commit early in the design process prior to planning approval being given and will also have concerns at how the requirements can be reconciled with accounting treatment considerations

H17
A. Boroughs should seek to ensure that local and strategic need for purpose-built student accommodation is addressed, provided that:
1. at the neighbourhood level, the development contributes to a mixed and inclusive neighbourhood
2. the use of the accommodation is secured for students
3. the accommodation is secured for occupation by members of one or more specified higher education institutions
4. at least 35 per cent of the accommodation is secured as affordable student accommodation as defined through the London Plan and associated guidance
5. the accommodation provides adequate functional living space and layout.
B. Boroughs, student accommodation providers and higher education institutions are encouraged to develop student accommodation in locations well-connected to local services by walking, cycling and public transport, but away from existing concentrations in central London as part of mixed-use regeneration and redevelopment schemes.

- concerns that the 35% affordability requirement will further constrain the development of private PBSA in London which will apply further pressure on the capital’s wider housing stock
- querying the justification for applying the affordable housing threshold to all PBSA, even where nominations have been agreed – the BPF believes that schemes in London which can demonstrate that they directly link with a higher education provider should have the 35% affordability requirement removed and that where 100% of the rooms in the student development meet the affordability criteria, there should be no need for a nominations agreement with a university.

The consultation closed on 2 March 2018. We await the outcome, but do not expect to see any significant amendments to draft Policy H17.

Further, we anticipate that local planning authorities across the UK will follow suit and adopt similar policies to address the affordability issue. This will place a further strain on the financial viability of potential new PBSA projects and developers will be working hard to try to counterbalance the impact by interrogating other development costs, including the costs of construction.

The BPF’s concern about the VAT consequences of requiring a link to specified higher education institutions should be alleviated by the outcome of the Summit Electrical case which we consider in the tax update on page 18.
Rising construction costs – modular construction: getting the right fit

The costs of construction continued to rise throughout 2017, with both material and labour costs on the increase. AECOM’s cost indices, published in Building Magazine on 19 March 2018, state that between Q4 2016 and Q4 2017, the building cost index rose 4.2% and the mechanical cost index rose 4%. Such increases are forecast to continue into 2018 with increases in input costs offsetting any predicted deflationary effects. As a consequence, many developers, in both student accommodation and other sectors, are looking at ways to mitigate the effects of the current market and to protect margins, and one of the ways in which developers are seeking to do this is through the use of modular construction.

Modular construction (also referred to as ‘off-site construction’) can mean anything from small prefabricated elements such as bathroom ‘pods’ or façade systems constructed in a factory away from the construction site, and delivered to site fully fitted out and tiled ready to be incorporated into the on-site structure, up to full apartments, where only the central core is constructed on site and the rest of the building is constructed off-site.

The benefits of modular construction mainly derive from cost savings – whilst modular construction is often more expensive than standard construction, the shortened construction period on site more than compensates. Work on the ground can be carried out in parallel with the construction of the modules and, because the modules are constructed in a factory setting, delays due to adverse weather are mitigated. In addition, less labour is required on site as the majority of the work can be carried out at the factory utilising local labour. There does need to be a critical mass of construction to make modular construction financially viable given that it is, effectively, a production line that needs to be set up specific to a particular building or a number of buildings to the same specification (150+ rooms has been suggested as a guide).
Whilst historically ‘pre-fabs’ have had a bad reputation as being lightweight, temporary looking, not durable, depreciating in value and with a high lifecycle cost exposure, quality is improving and with a maturing supply chain there are now a number of products on the market which have changed these perceptions.

However, there are still a number of issues specific to modular construction that need to be considered by developers and funders, and we have summarised some of the key legal points below.

**Quality** – quality control is potentially more difficult than traditional construction as manufacturing issues are difficult to rectify once the module is on site. Developers and their funders need to have a presence at the place of construction to be able to monitor and inspect the modules and identify any issues before they leave the factory. Rights of access and inspection to the factory will be required along with a right to be present for all tests carried out on the modules.

**Interface** – there needs to be clear risk allocation between the structural engineer responsible for designing the frame or core, the mechanical and electrical engineer responsible for designing the cabling and plumbing and the design of the modules, as there is less scope for correcting ‘design clashes’ than when traditional construction methods are used.

**Fixing design** – modular construction requires both the design of the overall project and the detailed design to be fixed at an early stage, so that the modules can go into production. Once that process is underway design changes are very difficult and expensive to implement.
**Payment** – significant advance payments are usually required to be made to the module supplier, due to the bespoke nature of the modules. Developers and funders therefore need to ensure that there is sufficient security over the modules and the components within them at all stages of manufacture. This can be achieved (to some extent) by third party bonds and vesting agreements. We have also seen funders take a charge over the factory and plant where the modules are being constructed, but this may not be possible in many cases.

**Title** – there are two title issues which require specific consideration when it comes to modular construction. One is ensuring that the developer or funder has title over the constructed modules before their delivery to site. The second issue is that often a developer will provide certain elements of the modules to the module supplier for the supplier to incorporate into the module, such as tiles, or white goods, so any contract needs to deal with title in the developer’s goods to ensure that title is retained.

**Insolvency Risk** – in the event of insolvency of the module supplier, it will be difficult to find another supplier that can continue to deliver modules to the same specification, and it will have a huge impact on programme, certainly more so than finding a contractor to continue to build out a traditional construction project. Therefore it is critical to understand the financial covenant strength of the modular supplier and obtain appropriate performance security through bonds or guarantees or to look to cover off the risk through insurance.

**Transit Risk/Insurance** – the risk of damage to the modules in transit needs to be considered and the risk allocated appropriately, backed by suitable insurances.

Modular construction is clearly going to play a key part in the future of construction and has the potential to revolutionise the construction market but developers and funders must ensure that these key risk areas are addressed if they are to reap the benefits.
HMO licensing reform – disappointing news for PBSA providers

The approach to HMO licensing of student accommodation properties varies greatly between different local authorities. This trend looks set to continue, with the recent government response to a consultation proposing to extend the scope of mandatory HMO licensing, without taking forward proposed licensing discounts for PBSA. Indeed, the Licensing of House in Multiple Occupation (Prescribed Description) (England) Order 2018 (SI 2018/221) (“LHMO 2018”) brings into force some of the changes promised by the government as a result of its consultation.

Most significantly, the extension of mandatory licensing in the LHMO 2018 will mean that most HMOs that are occupied by five or more people who do not form a single household will require an HMO licence, regardless of the number of storeys. Mandatory licensing currently only applies to HMOs of three or more storeys. This change is expected to bring another 160,000 properties into the mandatory licensing regime, although most of these properties will not be PBSA schemes as purpose-built self-contained flats will be exempt.

However, as many PBSA providers will have experienced first-hand, it is not mandatory licensing that tends to catch PBSA schemes but additional or selective licensing introduced by the relevant local authority.

Additional licensing can be used to cover HMOs which are not subject to mandatory licensing (e.g. HMOs that are occupied by less than five people) while selective licensing can cover properties which are not HMOs. For example, some local authorities have introduced selective licensing regimes covering all privately rented properties within a specified area, including individual flats and studios within PBSA schemes.
The existing licensing exemption for student accommodation schemes that are occupied by full time students and managed by an educational institution pursuant to an approved code will continue to apply following implementation of the reforms. But such exemption will not be extended to PBSA owned and managed by private landlords who have similarly adopted an approved code of practice.

The government did recognise in its consultation paper that such licensing of PBSA schemes was not necessarily appropriate or proportionate, on the basis that PBSA tends to be well-managed and requires little local authority intervention. Accordingly, “significant discounts” on HMO licensing fees for PBSA were proposed. This proposal was not taken forward in the government’s response, nor in the LHMO 2018, amid concerns that such a discount may be seen as a barrier to local authorities being proactive in their enforcement of licence conditions for all purpose built HMOs. This decision will be disappointing for PBSA providers who are already accredited through an approved code and may well see HMO licensing fees as a duplication of costs and a means of subsidising local authority enforcement in relation to problem properties.

The extension to the mandatory licensing regime in the LHMO 2018, together with the government’s other reforms (such as obliging the Secretary of State to review these provisions at least every 5 years) will come into force on 1 October 2018. Transitional measures are included for HMOs that are already licensed under the selective licensing provisions, but which will be subject to the new regime from when LHMO comes into force.
Moreover, although currently in draft form, the Licensing of Houses in Multiple Occupation (Mandatory Conditions of Licences) (England) Regulations 2018 stipulates certain mandatory conditions to be included in HMO licences granted in England. The draft regulations include requirements for HMO licences to impose conditions requiring the licence holder to ensure that minimum floor areas are met and maximum occupancy numbers are not exceeded in relation to rooms used as sleeping accommodation. This may have an impact on the design of PBSA schemes that are caught by the mandatory or additional licensing regimes.
Taxing times ahead for offshore investors, but some positive news for developers

Changes announced at the Autumn Budget 2017 to the scope of capital gains tax will affect many offshore property owners, including those in the student accommodation sector. It was announced that, from April 2019, capital gains tax will be extended further to non-residents investing in UK commercial property. However, there will be an automatic “rebasing” to April 2019, which effectively means that gains accruing prior to April 2019 will not be subject to tax for non-residents.

The new rules will also apply to in-direct disposals of UK commercial property (ie exits via the sale of shares or comparable interests).

This will be a major change in the nature of taxation for non-residents and will affect owners of student accommodation that hold assets through offshore vehicles. The non-resident capital gains tax rules on UK residential property that were introduced in April 2015 include a specific carve out for purpose built student accommodation based on the number of bedrooms in the building and the number of days they are occupied by students. It is not expected that there will be any similar carve out for student accommodation with these rules – the stated aim is to establish a level playing field for taxation of non-residents and residents alike investing in UK property.

Also relevant for the student accommodation sector were the decisions of the First-tier Tribunal and Upper Tribunal in Summit Electrical Installations Limited v HMRC. This may result in cash flow savings for many student accommodation contractors who may find it more likely that they will be able to avoid paying VAT on sub-contractor’s charges.
The Upper Tribunal decision confirmed that a planning permission condition stating that a building has to be used for students attending a particular university does not preclude a building from being ‘designed as a dwelling’ for VAT purposes. The restriction on zero-rating by reference to separate use was concerned with situations where a property was in effect legally dependent on another property, so that it was not possible to dispose of the first property separately from the second.

The restriction in this case was based on specified universities at which the occupants studied, rather than particular properties. This was not a prohibition on separate use and the building could be a dwelling. Where a building is designed as a dwelling (or a number of dwellings) this broadly allows sub-contractors to zero rate their supplies for VAT purposes.

As set out earlier in this report, this decision should also offer some comfort to the concerns around the VAT risk with the draft new London Plan and requirement for nominations agreements.

The First-tier tribunal also determined that if a relevant residential purpose certificate has been issued by the end user to a contractor (which only allows a contractor to zero rate supplies) this does not prevent a sub-contractor from being able to treat the building as designed as a dwelling and hence zero rate its supplies on that basis. However, unfortunately this point was not confirmed in the Upper Tribunal (because HMRC did not appeal this point). Therefore, this aspect of the decision should be met with some caution as HMRC’s guidance in the area has not yet changed.
Staying ahead of the game

Competition for the development pipeline has become fierce and in order to secure prime product early, we are now seeing an increased “willingness” of investors to engage in forward funding arrangements with developers, often prior to planning consent being obtained. Perhaps this is more a tacit acceptance by some investors that early commitment to and funding of schemes is a necessity to stay ahead of the game.

Forward funding perhaps requires a greater reliance on the data providers in the industry in analysing local markets and getting the pricing models right.

These structures inevitably present their own legal nuances that need to be addressed in negotiating the right deal at the heads of terms stage.

A typical forward funding structure
Taylor Wessing’s key predictions for 2018

- **Growth of hybrid co-living schemes** – reacting to the constraints of the planning regime, we envisage seeing more new development schemes offering a mix of PBSA and co-living targeting the graduate market.

- **Launch of new operating platforms and brands** – we expect to see the launch of new operating platforms and existing operators increasing their capex on brand differentiation and focusing on the legal protection of their brands.

- **Increased collaboration with Universities** – with limited availability of land for new PBSA and highly competitive land uses, we expect to see greater teaming up between developers, operators and Universities to upgrade or rebuild existing stock.
A highly competitive market with potential new entrants to the sector – we expect to see an increase in the number and scale of acquisitions of equity stakes in established investment and operating platforms and intense competition for the development pipeline leading to more speculative forward funding of prime new development schemes.

A focus on innovation in the delivery of new PBSA – as well as an increase in adoption of modular construction, we envisage an increased uptake of proptech solutions to improve efficiencies in the delivery of PBSA.

Innovative operating – we expect operators to look at more innovative pricing models and opportunities to maximise income outside of academic semesters.

Beyond the UK – established investors in PBSA in the UK looking to other European and global opportunities.
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We would welcome the opportunity to explore any of the issues identified in this report with you in greater detail.
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