



# The student property market

## Trends in the UK student property sector

Ernst & Young's restructuring team has recently been involved in a number of assignments in the student accommodation sector, both from a formal insolvency and business advisory perspective.

These assignments have ranged from advising stakeholders in large national property portfolios, down to smaller localised portfolios.

We have strong Restructuring and Real Estate advisory teams who are experienced in advising both portfolio managers and funders in the sector and have significant sales and marketing capabilities.

The sector is one where a significant number of businesses are experiencing distress and in this paper we set out some of our insights into the general trends within this sector, why some portfolios are underperforming and the options and challenges in dealing with these portfolios.

Participation in higher education has shown steady growth over the past decade, with student numbers rising by c.30% between 2001 and 2010.

The increasing demand for student housing has generated attractive returns for investors, with rental levels in the student sector consistently outperforming other UK property sectors and RPI since 1995.

The sector has shown resilience in the economic downturn, with rental levels continuing to increase and occupancy levels remaining high. The relative exposure of more traditional real estate asset classes to the impact of the recession has generated a significant inflow of investment into the sector, making student property a key element of a balanced portfolio.

However, in recent years the direction of demand has moved, with a greater distinction between prime and secondary accommodation in terms of occupancy and rental levels achieved.

Prime accommodation is distinguished principally by location, but also by the standard of fittings and facilities with 'extras' such as ensuite bathrooms, wide screen televisions and fast broadband connections increasingly being provided by landlords in order to enhance rental values.

Research shows that the majority of students still live in traditional shared Houses of Multiple Occupation (HMOs). However, in response to the demand for prime accommodation, there has been significant investment in private purpose built apartments, with the number of purpose-built beds increasing by 21% between 2008 and 2010.



## The future of the UK student property sector

### **Government funding changes**

The recent review of Higher Education funding and the subsequent Government proposals (which include provision for universities to charge fees of up to £9,000 p.a.) have created significant uncertainty regarding the future of Higher Education.

Some commentators anticipate that the changes will have a minimal impact upon student numbers, and there has even been conjecture that students' disposable incomes may be higher during their university years given that repayment of tuition fees will be deferred until the student is earning £21,000.

However, the adverse publicity given to the funding changes may well have an impact upon overall student numbers, at least in the short term, with some potential students choosing to enter the workplace instead of continuing their education.

It is likely that the funding changes will lead to an alteration in the concentration of student numbers in various locations, with greater numbers of students applying to attend Higher Education Institutions (HEIs) with high academic ratings, and poorly performing HEIs suffering a drop in student numbers.

In May 2010, the Higher Education Statistics Authority (HESA) identified that 30 HEIs were in serious financial difficulty and that seven HEIs were on the verge of collapse. Therefore, it is feasible that the changes in funding could lead to the merger or failure of one or more HEIs, as students migrate to better performing institutions. This will have a significant impact on student landlords in these locations.

In addition, concerns about funding may lead to a greater number of students choosing a HEI near their family home, reducing overall demand for student accommodation across the UK.

The increased cost of Higher Education may also cause a trend towards lower cost accommodation, leading to downward pressure on prices, especially in relation to prime accommodation.

### **Interest rate changes**

Interest rates have been consistently low for a substantial length of time, and many property portfolios are able to service existing debt on this basis.

However, there may be an impact on the ability to service debt if and when interest rates begin to rise, as portfolio managers may not be able to implement rental increases given the issues discussed above in relation to the cost of higher education.

### **Refinancing problems**

Many student property portfolios are currently funded by relatively low cost debt obtained prior to the economic downturn. Given the changes in the financial markets and the deterioration in property values, it is unlikely that it will be possible to refinance this debt at an affordable cost.

As a result, there is significant potential for default in relation to existing facilities provided to student property portfolios, once these facilities come up for renewal.



## Why are some of the portfolios underperforming?

The impact of the changes in Government funding on student populations will be a key driver in the future performance of student property portfolios, although these changes are likely to have a greater impact upon portfolios which are already showing signs of underperformance.

Typical indicators of underperformance are discussed below:

### **Property location**

The portfolios which appear to be suffering are those which are located in cities which do not have high performing or multiple HEIs, and demand in these cities may be reduced still further given the likely changes in student populations.

In addition, the location of the properties within the cities is a critical factor, and landlords with accommodation in fringe locations generally struggle to achieve desired occupancy levels without discounting rental values.

### **Continuing capital expenditure**

Capital expenditure and ongoing maintenance costs are generally higher for student accommodation than for other classes of property asset.

Highly leveraged landlords have tended to defer capital expenditure in order to fund bank indebtedness.

However, without appropriate levels of ongoing investment, rental values can be adversely impacted and it is important for landlords to maintain the quality of their accommodation, given the need to attract new tenants on an annual basis.

### **Marketing**

Another key factor in ensuring portfolio performance is effective marketing to student populations. Occupancy for each academic year is principally dependent upon a critical two or three week letting period which usually occurs in January or February (particularly for HMO accommodation).

From our experience, landlords who fail to target this critical period with effective marketing are generally unable to achieve desired occupancy levels without discounting rental values.

Given the target demographic, the most effective marketing strategies now include the use of social media such as Facebook and Twitter, with many halls of residence now having their own pages.

There is speculation in the sector that the changes to university funding will lead to a shift in the traditional marketing window, with landlords entering the market earlier in the academic year in order to beat the competition and secure occupancy earlier in the lettings season.

### **University links**

Links with HEIs and compliance with university approved codes of conduct are important in terms of marketing and building credentials with potential tenants.

Universities are key stakeholders in the local community and can exert a powerful influence over student populations. As a result, landlords who fail to establish effective links may experience increased difficulty in achieving desired occupancy.



## What are the options and challenges in dealing with an underperforming student property portfolio?

There are a number of options available to funders when faced with an underperforming student property portfolio.

### **Owner led turnaround**

The first option may be for the owners to attempt to turn the business around. However, the underperformance is often a direct result of the owner's actions and they may not have the skills, experience or ability to deliver a successful turnaround.

It is probable that financial performance will be initially poor during a turnaround process and the funders will need to trust the owners to be capable of delivering a turnaround if they are to provide support during the transitional period.

Given the potential risks associated with pursuing a turnaround process, the funders may consider obtaining external assistance to provide support to the owner. Funders should also ensure that robust management information is provided throughout the process to allow performance to be monitored effectively.

### **Restructuring of debt**

Many student property portfolios are highly leveraged, having expanded substantially prior to 2008 given the availability of finance and increasing demand in the sector.

Given the high levels of lending and the impact of the economic downturn on property values, the Loan to Value ratio of many portfolios has increased, leaving the secured lender 'out of the money'.

In many cases, the portfolio is unable to provide substantial amortisation to reduce the loan to value ratio and in cases of significant underperformance, the portfolio maybe unable to service its debts from the net rental income generated.

However, in certain circumstances, funders may decide to offer flexibility in terms of interest and capital repayments, rather than opt for enforcement and insolvency.

Given the risks associated with deferring or rescheduling interest or capital repayments, trust between funders and owners is critical. In addition, funders may consider obtaining external verification of the financial forecasts relating to the portfolio to provide comfort in respect of the serviceability of the restructured debt profile.



### **Consensual sale**

In some cases, the owners and funders may agree that a turnaround is not achievable and a refinancing may not be appropriate.

However, in order to avoid the value destruction and additional costs which may occur in an insolvency process, it may be possible to agree a consensual disposal process, whereby the portfolio is marketed on a solvent basis.

Funders should consider taking advice regarding the structure of any sale, in order to maximise returns. In addition, it may be necessary to provide support to the business whilst a sale process is pursued, and funders should consider taking advice regarding the additional risks associated with this.

### **Insolvency**

Underperformance may result from external factors which are outside the owner's control, and in such cases, there may be no prospect of a successful turnaround. In other cases, stakeholders may choose not to support a turnaround, restructure or solvent sale process due to concerns regarding management, or due to a desire to exit the sector.

It is important that underperformance is recognised early to allow the funder time to consider all alternative options before an insolvency process becomes inevitable.

Given the recent deterioration in property values, any insolvency process is likely to crystallise a loss for the funder, and therefore it is important to maintain occupancy levels during the process, as the portfolio value is likely to be enhanced through a sale on a yield basis as opposed to a vacant possession basis.

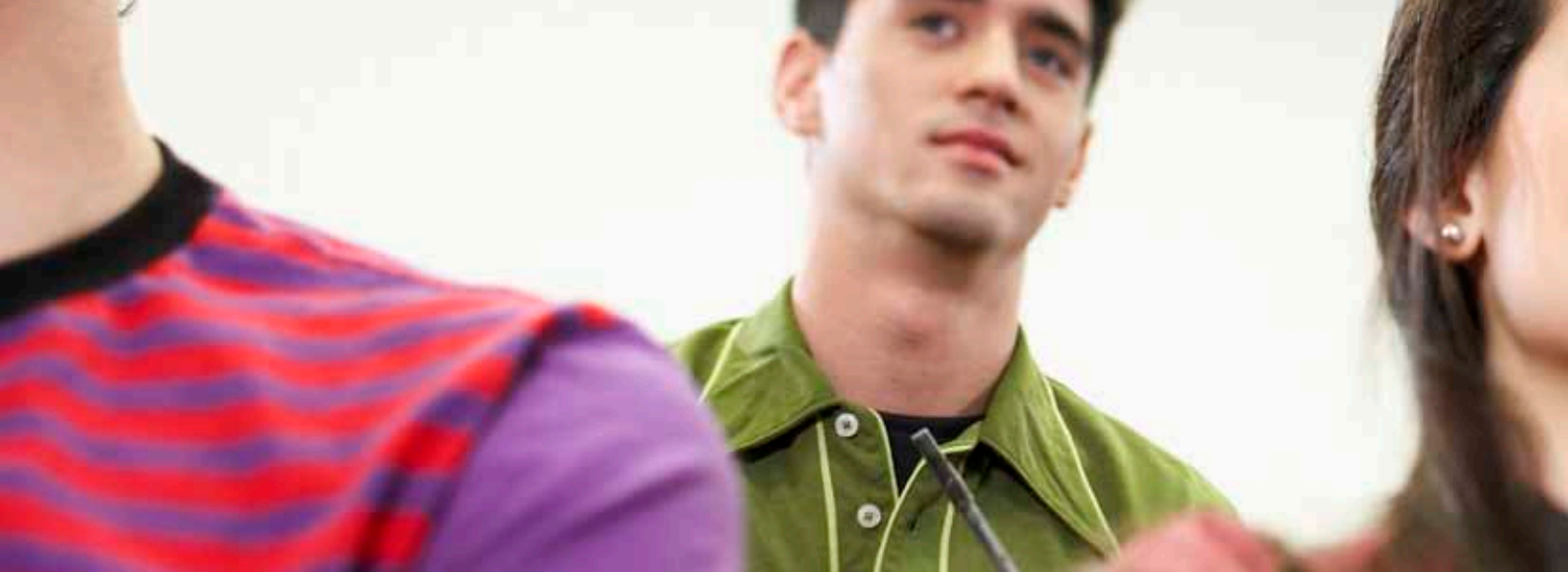
As a result, contingency planning is critical as there will be a requirement to continue providing services to existing tenants during the insolvency process, and it may not be feasible to continue to use existing management to provide these services.

In addition, it will be important to capture the rental income associated with the portfolio as quickly as possible and given the nature of tenants this is not generally a straightforward task.

## **Conclusions**

The student property market is facing considerable uncertainty and the impact of future Government funding changes is currently unknown. The deterioration in property values has reduced security available to funders and the changes to funding may reduce future demand and rental values and the ability of student portfolios to service debt.

As with all distressed business early recognition of problems will give time to properly consider the most appropriate way to deal with such situations.



## How can Ernst & Young help?

Ernst & Young have performed many assignments in this sector including advisory projects, independent business reviews and management of insolvencies. Some of our credentials in this sector are set out here, together with a recent case study.

### Independent business review and insolvency of a group of student property companies

#### Project summary and objectives

The lender had provided c.£28mn of lending to finance the purchase of various student properties during a period when property values were increasing.

A revaluation of the properties in December 2009 showed that the aggregate value of the group's portfolio had fallen to c.£22mn, leading to a breach of Loan to Value covenants. In addition, the business had begun to default on interest payments, leading to cash flow concerns.

#### Ernst & Young role

- ▶ Ernst & Young were initially engaged to perform a business review of the group in order to assist the lender in determining the options available.
- ▶ Management were uncooperative and the information made available for the business review was poor and incomplete.
- ▶ Ernst & Young advised the lender that the best course of action would be to initiate insolvency proceedings immediately.
- ▶ Subsequently Ernst & Young were appointed Administrators/Isle of Man Receivers/Liquidators over eight group companies, without the support of management.
- ▶ Ernst & Young's robust approach to this formal insolvency process has provided a clear exit strategy for the lender, with values being optimised in the long term through effective management of the assets in the short term.

#### Value delivered to client

- ▶ Given the lack of management information, the Ernst & Young strategy on day one was to secure key assets and information across the four trading sites with minimal impact on incumbent tenants.
- ▶ Following the initial review of the assets, three sites have been stabilised and are now trading profitably in insolvency proceedings. The lender now has full visibility over income streams and the enhanced performance of these assets will optimise the values achievable on disposal.
- ▶ Ernst & Young have negotiated with local universities and local authorities to re-establish the properties and ensure compliance with codes of conduct and health and safety regulations.
- ▶ The remaining site has been closed for health and safety reasons. However, strategies have now been put in place to ensure that sites are upgraded and repositioned in order to optimise future disposal values.



## Our credentials

This announcement appears as a matter of record only. March 2011

### Project Gorse GRPL & GWPL Scotland

Advisor to secured lender to  
£150 million residential letting  
portfolio across 12 UK cities

Appointed Administrators in  
March 2011

Ernst & Young acted as financial advisor to  
the bank and as administrators.



This announcement appears as a matter of record only. April 2011

### Project Norse

Advising the Administrators on  
value recovery from a property  
company comprising student  
accommodation, commercial,  
hotels and residential assets  
(£21 million)

Ernst & Young provided restructuring  
advisory services.



This announcement appears as a matter of record only. September 2011

### Project Loft

Advisor to secured lender to  
£31 million student property  
portfolio across four UK cities

Appointed Receivers/  
Administrators in July 2011

Strategy agreed with the Bank to  
continue to operate the properties  
whilst pursuing a disposal

Ernst & Young acted as Receivers/  
Administrators.




This announcement appears as a matter of record only. September 2011

### Hirondelle Wines Limited

Administrators of student  
property business in Sheffield  
providing accommodation to  
over 70 students

Ernst & Young acted as administrators of  
Hirondelle Wines Limited.



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