Is there an investment case for social and affordable housing in the UK?

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Currently around 70% of capital raised by Private Registered Providers to invest in social and affordable housing is from private, predominantly debt, financing sources. To date, there has been little investigation of the merits or otherwise of including these assets within institutional investment portfolios. This report, commissioned by the Impact Investing Institute and co-funded by Homes England and the Investment Property Forum, analyses the implications for portfolio performance by the introduction of these types of residential investment.

Sector risk and reward characteristics

Cashflow: Understanding the risks of underlying cashflows from a social or affordable housing investment is complicated by the range of tenures that exist within the sector, each with different bases for calculating and reviewing rent and/or receipt of revenue from disposals.

Social and affordable rents are not driven by market forces but are subject to government rent-setting regimes and, typically, linked with inflation, thus are less sensitive than commercial real estate to changes in the business cycle. These cashflows provide investors with diversification benefits in both multi-asset and real estate portfolios with attractive inflation hedging characteristics.

Governmental controls: UK government regulation of rents and benefits may affect future revenues from the sector. Reform of either could have a significant impact on projected cash-flows and, hence, investment viability.

Management: Highly granular portfolios with a mix of tenures require intensive day-to-day management. Private Registered Providers (PRPs) are also under pressure to ensure that homes meet the Decent Homes Standard including levels of energy efficiency and sustainability. Changes to regulations may create significant future capital expenditure requirements.

Development: The usual risks associated with construction may be exacerbated by the generally riskier and time-consuming residential planning process.

Capital deployment: Allocating capital to the sector requires investors to provide debt and/or equity, to existing Not-for-Profit Private Registered Providers (NFPRPs) and/or operate via a new for-profit Registered Provider (FPRP). Forming and operating a FPRP present additional hurdles to investors.

Reputation: There is a very real reputational risk for investors and fund managers from, for example, the enforcement of covenants in bonds and leases, as well as increased levels of scrutiny from local and central government, tenants, local communities, regulators and the media. Investors may be conscious of a potential for conflict between executing fiduciary duties and the provision of safe, good quality homes for occupiers.

Occupancy: Compared to private-rented housing, tenants in the social-rented sector typically occupy for significantly longer periods – 80% stay in the same unit for at least three years and 44% for over 10 years, compared to just 10% of tenants in the private-rented sector[1]. The social-rented sector also has low and stable vacancy levels with less than 1.5% of stock vacant over the past five years.

1 DWP Family Resources Survey.

Income security: Given this robust occupation profile, the explicit link between inflation and rents and lower gross to net leakage of cash associated with tenant turnover, operating profits have been remarkably stable for the sector, averaging 30% (27% excluding government grants) since 2010. Rent collection since the start of the COVID-19 pandemic confirms this with rates for 2020 around 97-99% – significantly above the 35-85% average rates reported for retail, office and industrial assets[2].

Investment options

(i) Debt

Typically, debt financing has been bonds issued by larger PRPs with the scale and resource to access capital markets directly, whereas smaller PRPs ordinarily access debt through aggregators issuing bonds secured against the assets of a number of different PRPs.

While market values have risen significantly over the last decade, interest rates have declined, with bond yields falling from around 5.5% in 2010 to 1.8% by the end of 2020. However, credit spreads have remained fairly constant post-2010 (when the number of issues increased significantly), with the weighted average spread over UK government gilts being maintained at between 110 and 160 bps.

The average rating of bonds from rating agencies is single A.

Whilst the amount of debt raised by the sector has increased, average interest coverage ratios (ICR) of around 1.6-1.8x and net gearing ratios (NGRs) of 35-40% have remained constant for the last five years.

(ii) Equity

To date, there has been limited equity investment from non-public sources (listed and unlisted funds), as PRPs have viewed this as more expensive and sometimes less aligned with the ethos of the sector.

Quoted equity opportunities include such specialist real estate investment trusts (REITs) as Civitas Social Housing PLC and Home REIT. However, the relatively short existence of these vehicles limits the availability of performance data, albeit they have outperformed traditional commercial sector REITs in the period since February 2020.

Private (direct) equity investment into social and affordable housing has grown more slowly, although several unlisted funds have been launched since 2015. As non-public equity investment in the sector increases there is likely to be significant innovation and differentiation in the operating models adopted, to ensure the alignment of interests between operator, investor and tenant.

Conclusions

Using the capital asset pricing model, adopting certain assumptions regarding the risk characteristics of social and affordable housing, the authors have established long-term, equilibrium risk and return expectations for the sector compared to those for other asset classes. They conclude that debt and/or equity investment in social housing should increase the risk-adjusted return of both multi-asset and real estate portfolios along the efficient frontier, with the greatest impact evident for lower-risk portfolios.

Strong credit fundamentals and low correlation with other real estate sectors and the broader economy support an argument that social and affordable housing provides resilient, stable and diversified cashflows and should become an increasing proportion of institutional investment portfolios.

Furthermore, social and affordable housing caters for housing need and has the potential to fulfil a key element of the ESG agenda for investors, notwithstanding the possibility of future reforms to regulation of the sector and benefits system. Active dialogue between stakeholders, including government, should help to mitigate the risk of adverse changes.

To ensure that risk is apportioned fairly across stakeholders, it is important that private capital investment into the sector (both equity and debt) aim to achieve a fair, long-term risk-adjusted return within a robust framework covering financial, impact and ESG factors.

2 REMIT Consulting, Regulator of Social Housing