Cheyne
CAPITAL

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AFFORDABLE HOUSING: WHAT'S NOT TO LIKE?

Much has been written on the ethical reasons to invest in UK affordable housing. Those arguments are well understood. What we are going to focus on here is the financial investment case.

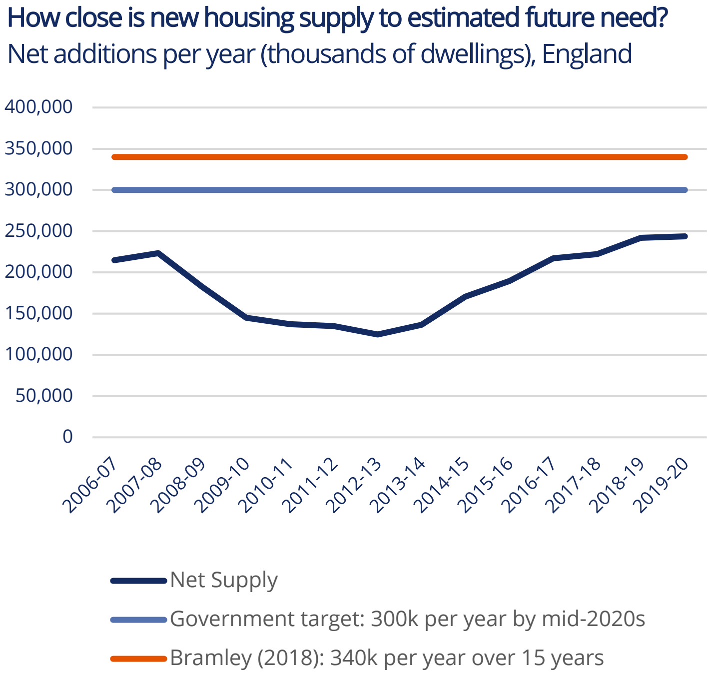
Executive Summary

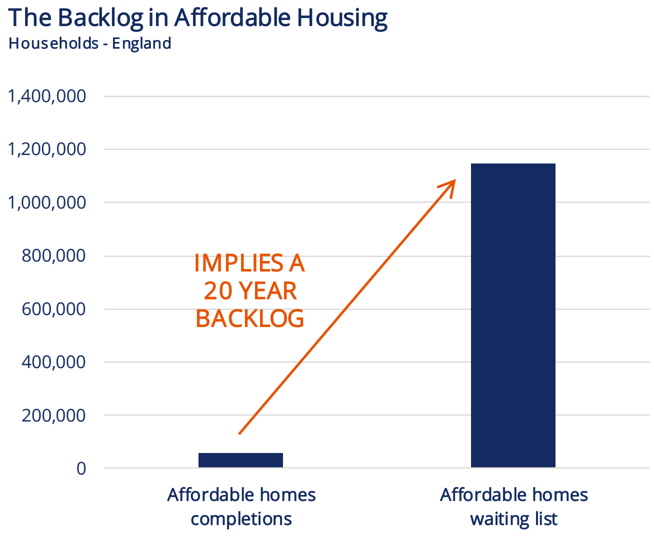
- Supply/demand dynamics imply a 20-year backlog in UK affordable housing
- We believe that the net yield on a diversified portfolio of affordable housing and social care assets should be approximately 5%
- In a 'downside' scenario, assets could be let at full market-rate rent in the extremely unlikely event that affordable housing tenants could not be found
- UK residential has been higher yielding and less volatile than other main property asset classes (office, retail, industrial)
- This paper gives the reasons why we find certain types of affordable property investment compelling and avoid shared ownership assets
- Having now managed this strategy in both closed and open-ended funds, we favour an evergreen structure as the buyer base for these types of assets is stratified which eliminates any portfolio effect on exit. An evergreen structure also aligns with our long-term commitment, our investors' need for sustained, inflation-linked cashflows, and our lessee/tenants' preference for ownership stability

First, and also well-known, are the supply/demand dynamics. The Government's target – set in 2017 - is to supply 300,000 new homes per year by the mid-2020s[1]. Research commissioned by the National Housing Federation (NHF) and Crisis from Professor Glen Bramley at Heriot-Watt University identified a need for 340,000 homes each year in England to 2031, including a need for 145,000 affordable homes. The report (published in 2018) estimated that there were 4.75 million households in housing need across Great Britain.

As the below chart shows, net supply has been increasing, but the highest rate achieved to date was 244,000 homes in 2019/2020 of which 57,644 were affordable[2]. Annual net supply of all types of homes would need to increase by another 23% to meet the government's target and by another 39% to meet the NHF/Crisis target. Research conducted by Savills on behalf of Shelter (June 2020) predicted 84,000 fewer homes would be delivered over 2020-21 as a result of the pandemic, with overall output falling to 171,000 homes. There is also concern that the well-publicised need to deliver affordable housing at pace may result in an impact on the quality of housing being delivered.

Moreover, some commentators have questioned the extent to which an increase in housing supply alone can directly improve affordability.





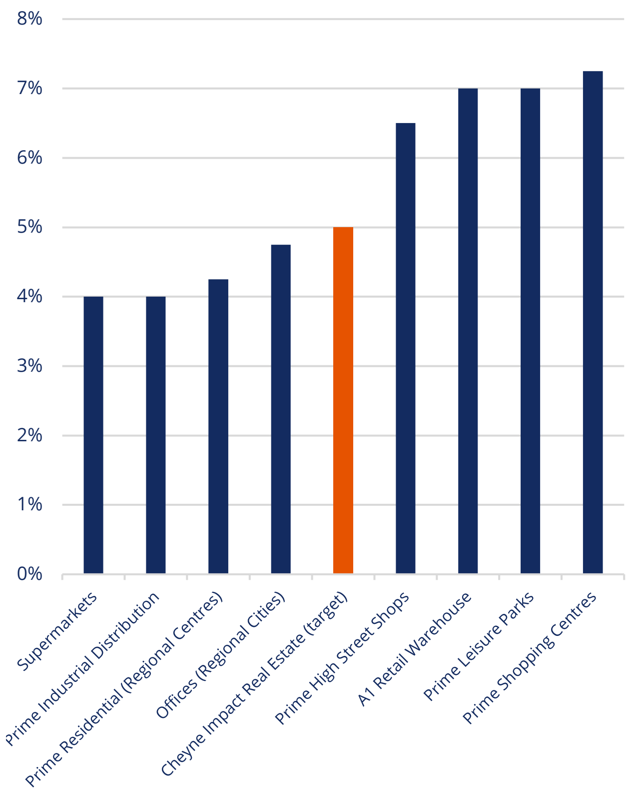
Sources: 1) House of Commons Briefing Paper, 14 January 2021 (MHCLG, Live Table 120; ONS, Household projections for England: 2016-based); 2) Homes England

Secondly, if you invest in affordable housing, what's the worst that can happen? To be clear, we are not talking here about sub-standard property created purely to be affordable housing. Cheyne Impact Real Estate develops or purchases property of private sector standard and ensures that a significant proportion is provided at discounted rents to those most in need. The properties are always 'tenure blind' with absolutely no difference in specification or service between full-market rent and discounted rent homes. The worst that can happen is that tenants cannot be found for the discounted rent homes and these therefore need to be rented at market rate. This scenario seems extremely unlikely to us. In November 2020, a study commissioned by the Local Government Association and social housing groups warned that the waiting list for council housing in England would almost double to two million people in 2021 as a result of the pandemic.

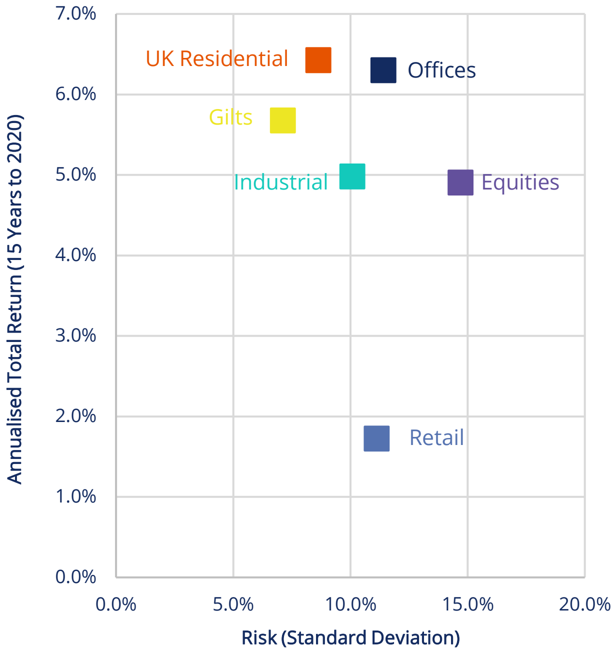
Thirdly, our experience shows that the distributable yield on a diversified portfolio of affordable housing, supported living and social care assets can be approximately 5% and is inflation-linked. Mostly funded by long-term leases and backed by housing benefit, the income stream is extremely visible and stable. With the supply/demand imbalance already mentioned, voids are rare, and, where there is a lease in place, may not even be a risk applicable to investors in any case. Compare this to other long-term, stable, inflation-linked income streams, such as UK 10-year Gilts, which currently offer a negative yield.

Finally, for real estate investors, compare this to other real estate asset classes today. In a previous paper we have demonstrated the higher stabilised yield of Cheyne Impact Real Estate than Build to Rent (BTR) investments, mainly due to in-house development enabling higher origination yields, as well as the incorporation of higher yielding supported living and care investments. But compare this also to today's yields on other property asset classes, not to mention their volatility.

Net Investment Yields Q1 2021



Long-Term Returns versus Volatility



Sources: 1) CBRE March 2021 for non-Cheyne data; 2) Savills, MSCI, Thomson Reuters

TYPES OF AFFORDABLE HOUSING INVESTMENT

If you have concluded that affordable housing provides for a robust investment with a stable and defensive income profile, the next consideration is the type of affordable housing to choose. Options include:

GENERAL NEEDS AFFORDABLE RENT

Rents typically set at 80% of market rent for affordable housing and 45-50% of market rent for social housing with tenants allocated from council waiting lists. We favour assets with a mix of tenures to avoid stigmatisation. However, our first ever development – in Luton in 2015 – demonstrates that the numbers can work with 100% affordable housing (in this case below Local Housing Allowance) if the development is on council-owned land. Properties can be let to local authorities or housing associations on long-term fully repairing and insuring (FRI) leases to provide security of tenure, or can be managed by a private operator if the local authority or housing association prefers not to be burdened with a long lease.

Cheyne's investment in Luton

Gross development value	£9.1m
Number of homes	80
Type	Affordable housing
Stabilised yield	5.3%, inflation linked

KEYWORKER RENT

Whilst institutional investment into the Build to Rent (BTR) sector has led to the much-needed delivery of housing, it has inadvertently resulted in creating high rental inflation in the major city centres across the UK, making the housing less affordable and pricing out local keyworkers. Cheyne strives to disrupt this model and has proved the concept by bidding against BTR funds and successfully securing an attractive city centre site and then installing a social covenant to ensure that 35% of the apartments are allocated to local keyworkers at long-term discounted rents. The discounted rents take into consideration the council's Local Plan to ensure that, based on average keyworker salaries, the discounted rent does not exceed – in this case – 30% of net income. Again these schemes can either be let on long-term leases or managed by a private operator.

Cheyne's investment in Manchester

Gross development value	£34m
Number of homes	144
Type	35% keyworker rent
Expected stabilised yield	4.3%, inflation linked


TEMPORARY/EMERGENCY ACCOMMODATION

Certainly an impactful investment considering that the tenants might otherwise be homeless, and bearing in mind that local authorities will save money through a long-term lease which gives them security of tenure compared to their other options such as emergency B&B accommodation that cannot be regarded as a long-term solution. The number of households in temporary accommodation has been rising since December 2011 and, in England alone, stood at 98,300 households in June 2020 including 127,240 children[3]. However, property used for this type of housing is often converted from other uses (such as office space) under Permitted Development rules and those converted before the new legislation of 30th September 2020 may not meet minimum space standards. This is particularly concerning given that households can remain in temporary accommodation for multiple years and even decades, so particular care must be taken when underwriting these investments.

Cheyne's investment in Barnet

Gross investment value	£25m
Number of homes	75
Type	Temporary accommodation
Stabilised yield	3.4%, inflation linked

SHARED OWNERSHIP

An area in flux currently given the changes announced on 1st April 2021. As an Impact strategy, this model has not appealed to us historically given the skew of advantage in favour of landlords rather than occupiers as exemplified by only 2 - 3% of households staircasing to 100% per year, and the much-publicised issues with repair bills and short leaseholds.

The key changes announced on 1st April include:

- Reduction of the minimum initial stake that occupiers can purchase from 25% to 10%
- Ability to staircase in 1% increments, rather than the previous 10%
- Landlords to be responsible for major works and external repairs for the first 10 years, on new-build properties, whereas all repairs and maintenance were the responsibility of occupiers previously

These go some way to redressing the previous issues but question marks still remain over the ability of occupiers to secure a mortgage on the new minimum ownership threshold of 10%; the size of service charges; and tenant responsibility for building repairs and maintenance after the first 10 years, or from the outset if the property is not a new-build. The issue of Shared Ownership tenants bearing the full cost of cladding replacement, sometimes in excess of the value of their initial stake in their home, has been much-publicised of late.

However, the new changes also make the sector less compelling for investors in our view.

As an alternative to Shared Ownership, in our Bristol project (which has six different tenures and was named by the World Economic Forum as one of the 10 exemplary ways in which global cities are tackling the affordable housing crisis), we have created our own type of Rent-to-Buy product whereby first-time buyers fix their purchase price at the outset. This price is then held for five years during which time they rent the property. In year 5, the tenant has the right to exercise their option to purchase the property at the price fixed at the outset of their tenancy, thus benefitting from any house price inflation. Assuming some modest HPI alongside a small deposit from the buyer, the properties are eligible for a first time buyer mortgage, giving the purchaser full control of the property.

Cheyne's investment in Bristol

Gross development value	£26m
Number of homes	161
Type	Mixed tenure, with rent-to-buy
Stabilised yield	4.3%, inflation linked

SUPPORTED LIVING

Supported living accommodation allows people to live in their own homes, within a community and close to families and support networks, rather than in residential care. Supported living homes may accommodate two or three residents with a shared carer. The Regulator of Social Housing has highlighted the potential pitfalls of investment in this asset class which have come about through the use of thinly-capitalised housing associations and the mismatch between housing associations' long-term inflation-linked leases and much shorter agreements with care operators. This could cause potential points of break in rental income due to a care operator failing to renew its agreement. These risks can be mitigated through a long-term lease with, for example, a charity which is providing both accommodation and care to the tenants. Given the security of the benefit payments provided for the end-tenants, we consider this to be a compelling investment if structured correctly.

Cheyne's investment with Thera

Gross investment value	£32m
Number of homes	90
Type	Supported living
Expected stabilised yield	5.9%, inflation linked

CARE HOMES

Unlike residential schemes, the planning system does not allow for 'affordable' equivalent allocations within care homes. Cheyne is striving to change the status quo by building state-of-the-art (all wet-room ensuite) care homes with 35% of beds allocated to publicly-funded residents. Local authorities and NHS clinical commissioning groups (CCGs) are able to allocate residents at subsidised rates which are typically between 20% and 30% below private pay.

Cheyne's care homes investment

Gross development value	£38m
Number of beds	206
Type	Care
Expected stabilised yield	6.0%, inflation linked

Overall, we favour a diversified portfolio covering a range of types of affordable housing, mitigating both investment and regulatory risk through diversification of location, lease, counterparty and tenant type. Being an Impact strategy, we also require the housing to be additional – providing new supply of affordable housing, either through development or by buying existing property that was not previously available as affordable housing – rather than aggregating existing stock.

OPEN OR CLOSED ENDED?

The above is one set of views amongst many. Where we do claim to have a unique insight is in fund structures. Having launched the UK's first affordable housing fund in 2014, we are able to share our experience, and lessons learned, from having managed both a closed-ended and open-ended structure to date.

Our first fund had a closed-ended structure, with its finite life partially driven by its pioneering status as it tested the market. However, consider the exit options for a closed-ended structure:

i) **a listing as a REIT –** not a viable exit for a fund which develops assets due to limits on assets in development, including a punitive tax charge on developments completed less than three years before a sale. On this point, we would note that the REITs in the market today are aggregating existing assets rather than creating additional stock. A REIT exit is also predicated on supportive capital markets at a specific point in time

ii) **a portfolio sale in one lot –** also an unviable option for a diversified portfolio of properties including Core+, Value-Add and Development assets – with diversified profiles in terms of tenure type, lease length and time horizon (in development/recently finalised/mature) – as these naturally attract different buyer bases. Moreover, unless the fund ceases new developments some years before its maturity, there is the prospect of having assets still in development at the time of maturity which could reduce their sale value. This also means that a closed-ended fund will likely experience only a short period of generating its stabilised yield once all developments are complete and before the portfolio has to be realised

iii) **sale of individual assets to different buyers –** in our experience, the only possible outcome for this type of portfolio. Therefore, we can conclude that each asset has performed well and in line with expectations but there is no potential for an 'aggregation premium' to give a portfolio-level valuation uplift on exit

We feel these types of long-term assets, and the typically long-term outlook of the investor base, are better suited to an evergreen structure without an artificially-created, and potentially – for some assets – inappropriate, date on which assets need to be realised. In our view, the ideal structure should aim to deliver liability-matching income to investors but also provide redemption windows in case liquidity is needed. Moreover, although social covenants are incorporated into our leases so that their impactful features will survive any change of ownership, we take great pride in our properties, which we have created with the sustainable mindset of long-term owners and can continue to give both investors and tenants comfort if the assets remain under our governance.

The following is an extract from the most recent independent social audit of our first fund:

"..the Fund has offered genuine value to local authorities compared with their other options for delivering affordable housing. This is despite the Fund not generating its impact through concessionary returns. In theory, this suggests that other private investors can also offer attractive finance to local authorities and others without sacrificing return. Moreover, our sources have consistently reported that the quality of homes delivered by the Fund is higher than what is generally available for affordable housing, providing a new standard of what should be possible."

(The Policy Institute, King's College London, Final Report & Reflections, February 2021)

1. House of Commons Briefing Paper, 14 January 2021
2. MHCLG
3. House of Commons Library, 26 November 2020

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