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UK Property Multi-Manager - Affordable housing briefing

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Introduction

This note discusses the research case for investing in affordable housing and assesses the options available for pension funds looking to allocate a proportion of their property portfolios to the sector. It considers the likely portfolio implications for risk and return and highlights issues we think should be taken into account by investors considering an allocation to the sector.

Market overview

The case for investing into the affordable housing sector in the UK is supported by demand and supply fundamentals. Official projections estimate that the number of households in the UK will grow on average by 272,000 per year between 2008 and 2033. In England this equates to 5.8 million extra households - a 27% increase. However, most commentators agree that the supply-side is not keeping pace with demand. Even before the financial crisis of 2008, the UK wasn't building enough new homes and the situation has deteriorated over the past five years. The number of new homes completed in the UK fell from 219,070 in 2006-07 to 140,790 in 2010-11, a drop of 36%.

Chart 1. Capital value of asset classes compared

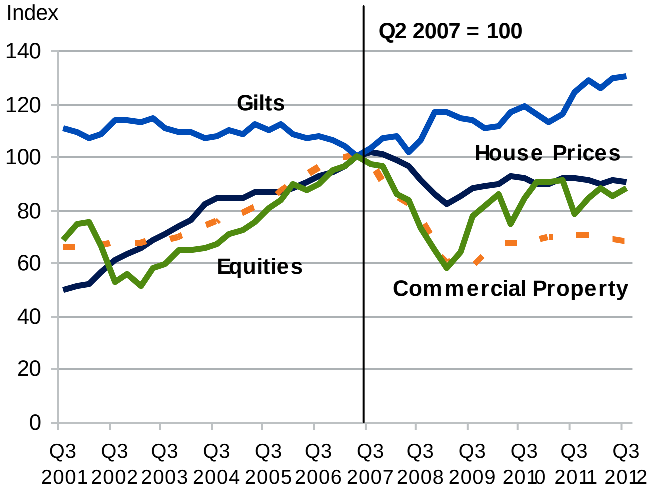
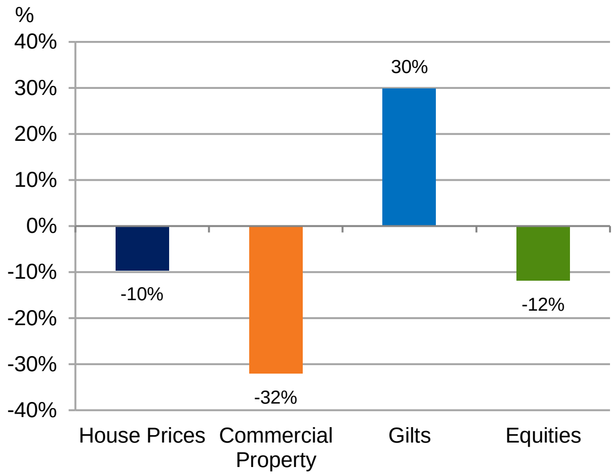


Chart 2. Change in asset class values since Q2 2007



Source: Investment Property Databank, Nationwide House Price Index, Thomson Datastream at 30 September 2012

To some extent these imbalances in supply and demand explain why the fall in house prices since mid 2007 has been less pronounced than commercial property (10% versus 32% - see charts 1 and 2 above) where supply and demand dynamics have been quite different. But this relative resilience in valuation has its consequences for occupiers. Affordability is still a major hurdle for potential home owners, particularly for first time buyers. The ratio of house prices to incomes remains high (chart 3). These ratios have been impacted further by the fact that since the credit crunch banks have rationed mortgage lending by doubling the size of the required deposit from 5-10% to 15-20% of purchase price (chart 4). Research by the Council for Mortgage Lenders shows that the proportion of first time buyers aged under 30 who are able to buy without assistance from their parents / grandparents has fallen from 65% in 2005 to 22% in 2011 as a result.

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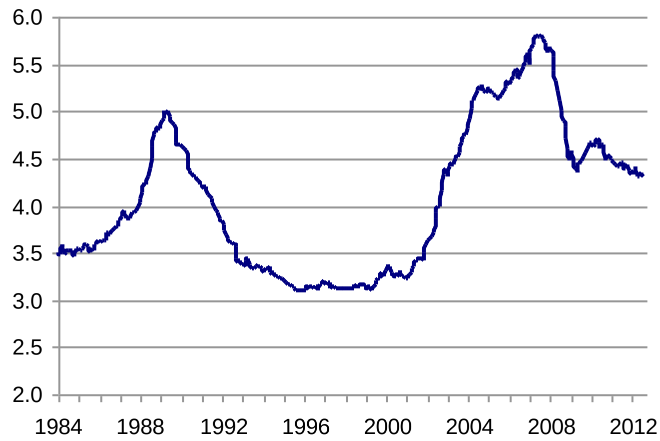
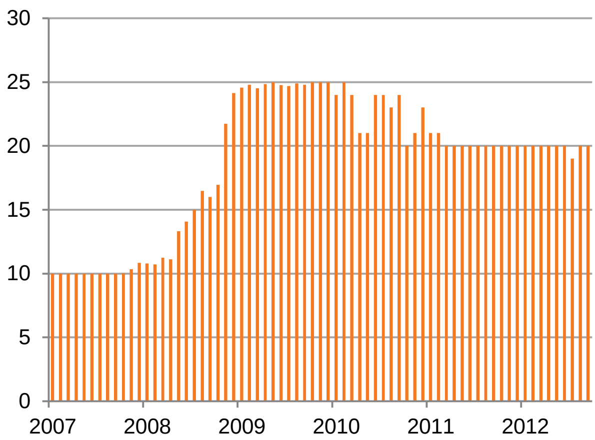
Chart 3. House Price: Average Earnings Ratio



Source: Thomson Datastream at 31 July 2012

Chart 4. Average deposit paid by First Time Buyers (% house value)



Source: Capital Economics at 30September 2012

Given these themes the private rented sector is increasingly the only option available for many households, as they are unable to access social housing due to eligibility constraints and unable to afford owner-occupation. The number of households who rent private accommodation has grown rapidly as a consequence, from 2.5 million in 2006 (12.2% of the total), to 3.6 million households (16.5%) in 2011 (source: Department for Communities and Local Government[1]). Around half of this growth is households with children. The number of families in private rented accommodation has increased from around 500,000 to around 1 million in the last five years (source: Shelter[1]). If recent trends continue, then 20% of all households will live in private rented accommodation by 2020.

The opportunity for investors, particularly in the affordable end of the market rent space, could be significant. However, the value of rented property is ultimately determined by its vacant possession value in the owner occupier market and given the relatively modest correction in house prices since the credit crunch, we expect capital growth in this sector to be flat over the next few years. The key question then for investors is how to access a market where rents are low by definition and capital growth is expected to be flat while still achieving the investment performance objectives of their portfolios.

The next section of this report tackles this question by discussing the key considerations undertaken by Schroders before investments are made on behalf of a pension scheme's property portfolio and how investment into the residential sector and affordable housing in particular currently compares.

Key investment considerations

Before undertaking any investment on a pension scheme's behalf the investment is appraised and its suitability for inclusion in the property portfolio assessed.

This initial appraisal generally focuses on the following areas:

1. Total return expectations
2. Portfolio risk considerations
3. An assessment of the Management Team

[1] From Building New Homes for Rent – Building and Social Housing Foundation (BHSF) at October 2012

1. Total return expectations

One of the most important assessments made is whether the investment is expected to meet the performance objectives of the property portfolio. Schroders' performance objective is generally to achieve total returns which exceed the benchmark by 0.75% per annum over a rolling three year period net of our fees. The long term returns of the benchmark have been 7% per annum (source: Investment Property Databank). As a consequence, investments are likely to be suitable for the portfolio if they can achieve total returns of around 7-8% per annum over the medium term.

2. Portfolio risk considerations

The expected total return of an investment is not the only criteria by which we judge opportunities. Investments must also meet the investment risk restrictions contained within our mandates. These are typically focused on promoting a diversified spread of investments within the portfolio, limiting exposure to speculative development and leverage while maintaining a level of liquidity to enable returns to be realised.

3. Assessment of the Management Team

A final key area of due diligence focuses on the third party management team whose responsibility it is to source and manage the underlying property assets. Among other things property managers should be able to demonstrate proven track records of performance, financial stability, repeatable investment processes and robust risk management and governance procedures.

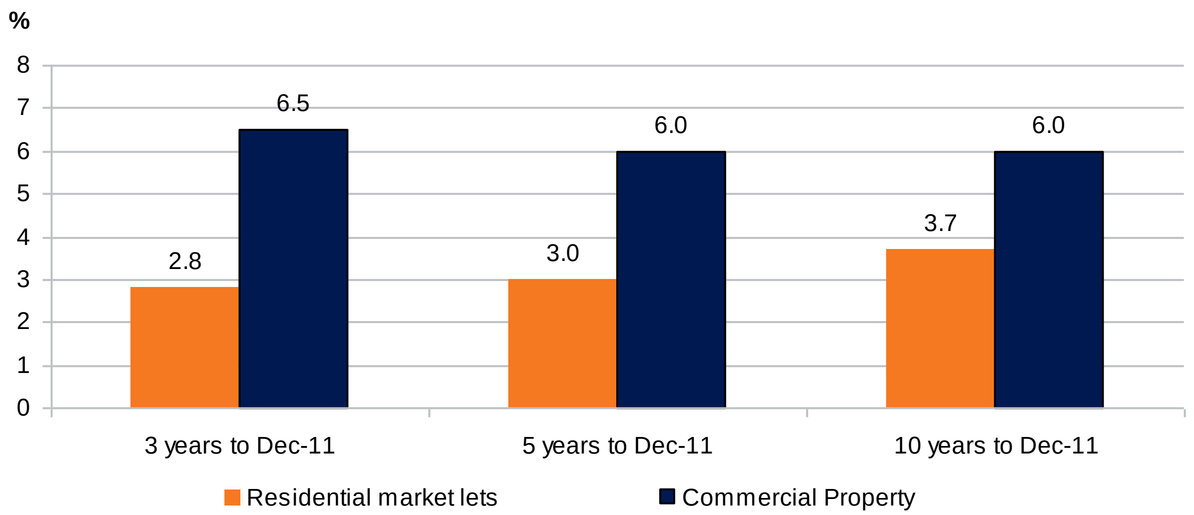
How residential property measures up

There are no residential funds (excluding student accommodation) in our clients' property portfolios nor are there any in the AREF/IPD Pooled Funds Index, which includes the portfolio's benchmark and which in total comprises £30 billion property assets across 60 property funds. In our view the key reason why institutional property investors are currently reluctant to invest in the sector boils down to income returns.

Management costs for residential property are high relative to commercial property where leases are usually structured on an FRI (fully repairing and insuring) basis. These costs reduce the net income return receivable by investors and are one of the main reasons that the income yields for residential property are not typically as attractive as those of the commercial property sectors (see chart below).

For pension funds investing in property who are seeking returns of around 7-8% per annum the bulk of performance must therefore come from capital growth – higher house prices. In today's economic environment significant house price growth appears challenging.

Chart 5. Net income returns from residential versus commercial property



Source: Association of Real Estate Funds and Investment Property Databank at June 2012

In our view, to meet the total return objectives of the portfolio an investment in this sector would need to deliver an income return of at least 5% net of costs. It would then need to be able to deliver rental growth which matches inflation (assuming this to be 3%) to achieve a nominal total return target of 7-8%. As chart 5 shows, the net income return on residential property has been less than 3% over the past three years to December 2011. This implies that rents would need to grow at a challenging 5% per annum, roughly twice the rate of inflation, in order to achieve a return comparable with commercial property.

What are the investment options and how do they compare?

Despite the challenges in 'getting the numbers to add up' for institutional investors several potential investment models have emerged over the past eighteen months. These models fit into four broad areas: 'strip income', debt funding, shared ownership and land-led joint ventures. Each model is described below and its investment characteristics compared with the general investment objectives of our clients' property portfolios.

1. Strip income funds

A strip income property fund 'strips' the income and capital payments from its underlying assets. These investments are targeted at annuity investors looking for long term cash flows linked to inflation.

Under this model the freehold interest in residential property is purchased by the fund and leased to a registered provider or local authority for 40-50 years who use the proceeds to build social housing. Under the terms of the lease, the registered provider is responsible for letting the properties and for all ongoing repair, maintenance and void costs, and pays rent to the fund which is typically reviewed annually in line with the retail price index. The fund's initial investment is amortised over the lease term such that at the end of the lease ownership of the assets reverts to the registered provider.

These funds typically target annuity style returns. The examples we have reviewed are benchmarked against index linked bonds +1.5% per annum. On current pricing this implies a total return target of just over 4% assuming inflation of 2.5% per annum, significantly below the long term required rate of return for a pension fund's property portfolio.

This kind of investment has merit for annuity style investors looking for fixed-income style returns. However in our view there are a number of shortcomings for property investors. These are set out below:

- **Liquidity and investment duration**: The hold period for investors is 40-50 years
- **Total return expectations**: Total returns of 4% are more akin to the long run returns of gilts than commercial property
- **Social housing focus and housing benefit risk**: Social housing is primarily funded with housing benefits which at present is paid directly to the registered providers. Any changes to the level of housing benefit or the way that it is paid (e.g. directly to the tenants) could affect the revenue collected by the registered provider and hence its ability to meet its own rent payment obligations to the strip income fund.
- **No actual property investment**: At the end of the investment hold period investors do not necessarily own the land or property as the registered provider would have an option to acquire the assets at nil value. Ultimately, like a fixed income instrument, the return of this investment is not linked to the quality, or underlying rental growth of the property assets but the covenant strength of the registered provider and interest rates.

2. Debt funding

Over the past few years debt funds, which lend to the providers of social housing, have been launched to target investors looking for inflation linked cash flows. These funds offer private financing to registered providers to fund the development of social housing. The debt is secured on the property assets with a long-term maturity profile of 30-40 years. While the bank has a charge on the property assets during the term of the loan the properties are owned by the registered provider. These funds typically target long term nominal returns to investors of c4.5% per annum assuming inflation of 2.5%.

As a debt instrument, these funds are clearly fixed income investments. They also share a number of the shortcomings highlighted for 'strip income' investments. Namely, illiquidity and long term hold periods (30-40 years), relatively low long term investment returns (c4.5%), a focus on social housing tenure and no actual underlying property investment.

3. Shared ownership

Shared ownership is a form of house purchase whereby the purchaser buys a proportion of the home, usually from a local authority or housing association, and rents the rest. Over the past few years some companies have tried to raise equity to provide occupiers with funding on a portion of the property in return for 'rent'. This is very similar to the role a bank may play when providing a mortgage. However, the key difference is that the shared-ownership fund would actually own the property jointly with the occupier.

The typical terms of the shared-ownership proposals we have analysed are summarised below:

- Leveraged total return targets of 10% per annum
- The Fund charges occupiers 6-7% 'rent' on its share of the property, which is often linked to RPI.
- The occupier is responsible for 100% of the maintenance costs of the property as well as the full legal, agency and stamp duty costs incurred on the transaction.
- The occupier has a right to acquire the asset in full or in part after a period of time, usually five years. This is how the investors release their equity and crystallise their returns and is called 'staircasing'.
- The fund typically uses leverage (c30% loan to value) to enhance returns.

We think that the modelling assumptions of the proposals we have seen in this space have several shortcomings:

- **Affordability**: We question whether occupiers would be able to afford a 6-7% 'rent' charged by the fund especially if it ratchets up annually by RPI
- **Exit for investors**: There is also considerable uncertainty over whether occupiers would be able to buy back the fund's share of the property and when this might occur. As a consequence, the exit timing for investors in the fund is highly uncertain.
- **Transaction costs**: We also have difficulty justifying the allocation of 100% of the transaction costs to the occupier who owns a minority stake in the property.
- **Quality of the investment managers**: The managers promoting funds in this space have difficulty providing relevant and successful track records.
- **Modelling assumptions**: The modelling assumptions used for such funds typically assume a level of house price inflation and leverage to ensure the returns look attractive to investors. In general, we have found the modelling assumptions for house price growth and cost of finance to be questionable.

4. Land-led joint ventures

A land-led joint venture is where investors partner with a land owner, either public or private, to create an investment vehicle which funds the development of residential property on that land. The land is invested into the joint venture by the land owner while the investor commits equity. As such both parties have a stake in the joint venture and benefit from the returns it generates. The model can be used to fund different types of tenure, including market rent and affordable rent.

Equity investors enjoy a priority return on the investment such that an ungeared total return of c8% is paid to them before returns are paid on the land. However, once these returns are achieved the land-owner shares proportionately in the financial returns of the investment.

The advantages of this approach are that the land owner is able to kick-start its development project on its own time scale rather than selling the land to a developer who will start the development when it sees fit, which in the present investment environment may mean that development is delayed. For the equity investor, a total return is achievable which is comparable with the long term performance of commercial property and is commensurate with the risks of the investment.

The shortcomings of this model are:

- **That it is largely unproven**: while this idea is not new it has not been used prolifically to date. This is partly because it has not needed to be as the grant system has allowed registered providers to fund developments economically.
- **Land value**: The model depends largely on the value assigned to the land. Some land owners are unwilling to invest their land assets below the value they have assigned to it in their books in return for a share of the profits of the partnership.
- **Regulation**: There has been some uncertainty as to whether the injection of public land into a joint venture would need to go through the OJEU tendering process (Official Journal of the European Union). However, we understand that land-led investments would be excluded from this process.

The table overleaf summarises the key investment characteristics of the four investment models described above. In our view each have their merits and will likely all play a role in the funding of social, affordable and market rent housing over the coming years.

Table 1. Key investment characteristics of affordable housing investment models

	1. Strip Income	2. Debt funding	3. Shared ownership	4. Land-led joint ventures
Total Return target	c4% pa	c4.5% pa	10% pa	8% pa
Income yield	c4% pa	c4.5% pa	c6%	5%
Investment period	40-50 years	30-40 years	10 years (in theory)	5-10 years
Exit mechanism	Essentially an amortising investment with the Registered Provider having an option to acquire the freehold at zero value at the end of the term.	Fully amortising loan. Repaid at the expiry of the loan term.	Uncertain and dependent on occupiers' ability to 'staircase' – buy back some or all of the fund's share of the property	Sale after minimum hold period of 5-10 years
Property assets	The freehold is owned but subject to call option from Registered Provider at the end of the lease	No property ownership.	Owned jointly with the owner occupier	Owned in Joint Venture by investor and land owner
Is the investment accessible?	Yes, over a 12-18 month period.	Yes, over a 12-18 month period.	No suitable funds at present.	Not as a fund. Investments potentially available on a deal by deal basis.
Strengths	• Bond style cash flow returns linked to inflation	• Bond style cash flow returns linked to inflation	• Potentially attractive total returns.	• Potential returns comparable with long term commercial property. • Clear exit for investors • Both partners share in potential upside
Weaknesses	• Liquidity and investment duration • Relatively low long term investment returns (c4% per annum) • Social housing focus and housing benefit risk • No actual property investment	• Liquidity • Long term hold periods of 30-40 years • Relatively low long term investment returns (c4.5% per annum) • A focus on social housing tenure • No actual underlying property investment	• Affordability for occupiers • Exit for investors • Quality of the investment managers • Modelling assumptions	• Unproven model • Potential sensitivity for public bodies regarding the value at which land would be invested

Source: Schroders at December 2012

Important considerations

It is natural for Local Authorities to prefer funds targeting affordable housing to be directed to their own localities. However, before a Local Authority Pension Fund makes an allocation to this sector we would recommend that the following issues are considered carefully:

- **Fiduciary responsibilities of the Investment Manager:** The pension scheme's Investment Manger would need to believe that such an investment met the terms of its Investment Management Agreement before it could be recommended. In short, the investment would need to make economic sense for the pension scheme and be able to achieve the performance objective and investment restrictions set for the property portfolio.
- **Employer Related Investments (ERI)**: An investment by the Local Authority Pension Scheme into the Local Authority's social or affordable housing sector is likely to be classed as an ERI and therefore be subject to allocation limits.
- **Diversification:** The investments held in our clients' property portfolios are diversified in their exposure to properties and regional locations. A single investment into potentially one residential scheme and one location would not meet the typical diversification requirements of our mandates, particularly when the benchmark against which it is assessed has no or little exposure to residential, not least residential in one particular region or location.
- **Benchmarking:** In order to assess the relative performance of any residential allocation a suitable comparison would need to be made. At present the industry's current benchmark – a commercial property sample – would not be suitable as its investment characteristics vary significantly. A new measure to assess how a residential investment, and hence its investment manager, has performed would need to be agreed.

Conclusions

- The case for investing into the UK affordable housing sector is supported by demand and supply fundamentals. However, valuations in this sector are ultimately determined by vacant possession values in the wider owner-occupier market, which has experienced only a relatively modest correction in prices since 2007. As a result, investment returns in this sector are likely to be driven by rental income, which by definition is relatively low.
- For pension funds looking to allocate funds to this sector the key question then is whether investment returns from an allocation to affordable housing would be able to match the target returns set for their property portfolio (c7-8% per annum).
- We have assessed four main models for investment into the sector. Each offer relatively low returns or are as yet un-proven models.
- In addition, local authority pension funds would also need to consider the implications of investing in their own locality: Employee Related Investment regulations, diversification and performance measurement should each be considered carefully.
- One potential solution to the challenge of meeting 7-8% total returns would be to make an allocation to the sector outside of existing property portfolio mandates and measure the performance against a lower total return objective. A lower target return objective would mean that several 'strip income' and debt investments would become more eligible investments for pension scheme property portfolios.
- Similarly, the issues of ERI and diversification might be alleviated if an allocation was made to a pool of investments. For example, we could foresee regional local authorities pooling their allocations to invest in affordable housing across their regions. Ultimately, this idea would be feasible if investments can be structured to provide pension fund investors with required rates of return. This may involve land-led investment partnerships or some level of income guarantee by the public body.
- We would be happy to discuss either of these solutions further if they are of interest.

To discuss the themes in this article further, please contact Anthony Doherty, Property Fund Manager at anthony.doherty@schroder.com, telephone +44 (0) 207 658 6010 or Graeme Rutter, Co-Head Property Multi-Manager at graeme.rutter@schroders.com, telephone +44 (0) 207 658 6768.

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