UK affordable housing – the investment opportunity

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In the UK there is a structural mismatch between the demand for, and the supply of housing. Consequently, the cost of housing has increased rapidly, in excess of both earnings growth and wider inflation. This deterioration in affordability has led to a shift towards rented accommodation and increased demand for affordable housing. In the face of this pressure there are a number of significant obstacles keeping supply from responding. These include a lack of adequate funding for provision of affordable housing, supply chain dynamics and ownership of stock. This presents an opportunity for private investors to step in and fill the funding gap left by the withdrawal of government funding to the sector. An opportunity that is underpinned by very strong market fundamentals, with appealing investment characteristics and measurable social impact.

The backlog of housing need in the UK continues to grow

UK population growth has been rapid in recent history, driven by strong rates of natural change and net migration to the UK. Growth is expected to slow from this point but not dramatically. Meanwhile, falling household sizes have caused household formation to outpace population growth. This trend is expected to continue over coming decades which will support household formation rates. This combined with an existing backlog of housing need means the government has now set a target of delivering 300,000 new homes per year.

Estimates of the existing backlog of housing need range from 2 million to 4 million households. This housing need manifests itself in a number of forms, such as young adults continuing to live with parents, large households cohabiting in groups, households living

Figure 1: Housebuilding & household formation, 000s p.a.

Source: ONS, MHCLG

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in unsuitable accommodation more generally, and increased levels of homelessness. For all of these reasons addressing the issue is an important social and political goal.

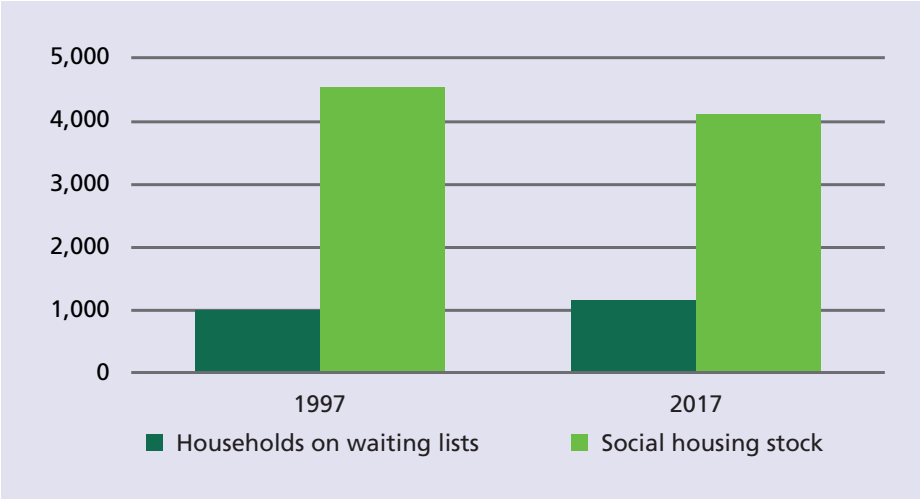
In contrast, recent rates of housebuilding have fallen far short of the 300,000 new homes per year target. Over the last five years, an average of only c.160,000 units have been delivered each year. Looking at the track record of housebuilding in the UK over a longer period we can see that the required new supply of homes has not been achieved consistently since the 1970s. There are a variety of factors that limit rates of housebuilding in the UK, meaning housebuilding will continue to be inelastic despite strong demand, and the supply-demand mismatch will continue to become more acute.

Shortage is most pronounced for affordable housing

The cost of housing, especially to own, has been consistently increasing ahead of inflation and earnings. These affordability issues this has created, together with more restricted access to mortgage finance since the GFC, changing demographics, job mobility, and lifestyle preferences have contributed to a dramatic shift in the tenure mix. The share of households living in privately rented accommodation has doubled since 2000. However, while the private rented sector has seen rapid growth, the same is not true of the social housing sector. This is not because demand is unchanged but rather because there has been no increase in supply to accommodate the demand.

There are currently 1.1 million households on Local Authority housing waiting lists in England alone. These

Figure 2: Social housing waiting lists & stock, England, 000s



Source: DCLG

households currently reside in bed and breakfast accommodation, private rented unfit for purpose housing or in other forms of temporary accommodation, costing the government an estimated 30%-40% more than the cost for provision of appropriate good quality affordable housing for such households. In fact, at no point over the past 20 years has there been fewer than 1 million households on waiting lists. Despite this consistent shortage of social housing, the total stock has actually contracted, falling by c.10% over the past 20 years.

Local authority housebuilding declined very sharply through the late 1970s and early 1980s, and since then has been negligible. The situation has been exacerbated by the Right to Buy scheme, which has transferred almost 2 million homes out of the social housing sector and into owner occupation. Housing associations stepped up their delivery of new housing in the early 1980s and again in the early 1990s, but these increases were not nearly large enough to meet the growing demand. The change in the providers of housing, along with changing demand and funding methods, has also seen the mix of tenures that are being delivered in the affordable sector change in recent years, away from social rent and towards affordable rent and shared ownership.

The investment opportunity

The affordable housing sector is still relatively immature in terms of private investment. Investments are typically sourced directly from developers or Registered Providers, and forward funding is a key route into the sector for investors. Importantly, forward funding facilitates the construction of new homes which has a greater social benefit than investing in standing stock. Investing in this way does have a number of associated risks, but these can be mitigated.

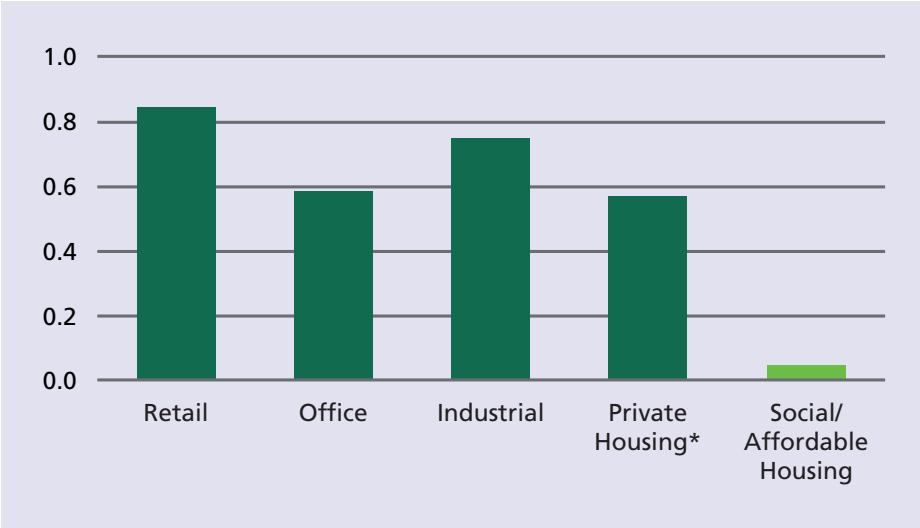
New forms of funding and innovation in the sector are on the rise because, ultimately, Registered Providers need to diversify their capital base away from a reliance on government funding to deliver their house building targets. This creates an opportunity for private sector equity investment for the long run – aligned with the requirements of government, Registered Providers and the population. Collaboration between the public and private sectors will be essential in tackling the housing shortage.

Attractive investment characteristics

The affordable housing sector is regulated and rental growth is set by government policy, which is index-linked. Hence, while underpinned by the same robust fundamentals, affordable housing rents are not driven by market forces. Rent setting policy, despite being revisited a number of times over the past 20 years, has provided consistent rental growth, influenced by inflation but not directly by other economic conditions. Typically, rental uplifts are index-linked and set on a five-yearly basis for the following five years, with further guidance provided for the subsequent five years (so policy and guidance covers a total of 10 years).

This means that rental levels are far more predictable than if they were set in the open market, and the income stream is one of the most secure and consistent in the real estate sector. Capital values are driven by the rental stream achievable, so capital appreciation is created in line with steady increases in rental income. Further stability of returns comes from occupancy rates in the sector that are consistently very high, and tenant churn rates that are relatively low helping to maintain a consistent income stream.

Figure 3: Rents correlations with GDP growth, 1998-2016



Source: MSCI, DCLG, ONS, CBRE Global Investors.

* Private housing rents data starts in 2006

Unlike other property sectors where property rental growth is typically strongly correlated to economic growth, affordable housing has almost no correlation because of the structural undersupply of affordable housing and the regulated nature of the sector. The affordable housing sector is therefore relatively resilient to economic shocks. In the same way, affordable housing is even more effective in providing diversification to a commercial property portfolio than private residential. Rents in the three main commercial property sectors are closely correlated, and private residential has a modest correlation with both commercial property and affordable housing, but affordable housing is uncorrelated with commercial property.

A sector that achieves high social impact

Institutional investors are placing increasing importance on the environmental, social and governance (ESG) impacts of their investment strategies. This is more broadly described as 'impact investing'. Impact investments are investments made into companies, organisations, and funds with the intention to generate positive social and environmental impact alongside a financial return. It was investors in equities who led this trend, where the ESG characteristics of individual investments would be more quantifiable than in other asset classes. However, investors in real estate are now following with initial emphasis on environmental and governance impacts.

Investment in social and affordable housing provides the capital needed for projects that support the social goal of providing homes to the households in

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greatest need. This strategy helps some of the most vulnerable in society and helps to alleviate the wider housing shortage. In doing so it is a strategy that contributes towards investors' ESG targets with a high social impact. It is likely that impact investing will continue to gain traction with a wide range of investor groups, which should mean a growing investor base and consequently increased liquidity in the sector.

Conclusion

Investment in the affordable housing sector is underpinned by a persistent demand-supply mismatch in the UK housing market which cannot be cleared, at least in the short term. The very significant requirement for new affordable housing requires funding as traditional forms of government funding have been removed, and this presents an opportunity to private investors.

For the investor, the sector offers secure, predictable income predominantly supported by the UK government, and (typically uncapped) index-linked rental growth. As such it is particularly well aligned with the objectives of liability-matching investors. As well as the attractive risk-adjusted return profile, investment in the sector has the potential to be an effective diversifier in a real estate portfolio, prove resilient through difficult economic conditions and make a significant contribution towards social objectives. These things mean that it is a sector with the potential to attract a wide range of investors and is likely to see rapid growth. It offers a solution to the challenge of financing and delivering housing.