BRITISH PROPERTY FEDERATION

Affordable housing partnerships: Catalysing investment in social housing

A toolkit for increasing the supply of affordable homes.

Contents

Executive summary

Demand for social housing is acute, yet supply from the traditional not-for-profit social housing sector is constrained by reliance on debt finance. Over the coming years it's likely supply will be further squeezed as housing associations face increased building safety and net zero cost challenges, alongside higher inflation, constrained income[1] and higher interest rates.

Against this backdrop equity investors see an opportunity to invest in the sector and boost supply of new social housing, either directly through development activity, or indirectly through acquisition of existing assets.

Partnerships between the not-for-profit and the for-profit sectors are emerging, with a shared ambition to deliver quality, sustainable investment in this sector.

This toolkit examines the potential motivations of the two sectors as they approach partnerships, offers some reflections on the process of finding the right partner, and then analyses the emerging models of partnership.

[1] https://www.gov.uk/government/consultations/social-housing-rents-consultation

Background

The last two years have seen a new kind of partnership emerging: between the traditional not-for-profit social housing sector and the newer for-profit social housing providers. In the anticipation that these pathfinder deals represent the start of a large and long-term trend, the purpose of this toolkit is to support ongoing discussions between these two related but different sectors.

Earlier this year the BPF and L&G published "Delivering a Step Change in Affordable Housing Supply[2]" exploring how investment in social housing is financed and the barriers to driving more investment into this sector. That paper started to lay out some of the potential opportunities for housing associations and investors to explore collaborative models which would bring substantial new resources both for housing supply and refurbishment.

Taking inspiration from that earlier work, this toolkit is intended as a practical guide to support market participants as they evaluate options for partnerships.

2 Delivering a step change in affordable housing supply | Legal & General (legalandgeneral.com)

Perspectives

The housing association perspective

Growth is part of the DNA of the not-for-profit – or Housing Association (HA) - social housing sector, with its mission to address the housing crisis and the shortage of affordable housing provision. The modern sector was born out of philanthropic efforts to improve housing provision for some of the worst off in society, and since the 1970s the sector has been an essential partner for government in improving housing quality and delivering new social housing.

The traditional model for a HA is to both own and operate social housing, with new acquisition of homes financed through a combination of debt, government grant and retained surpluses. Financial surpluses are not distributed as profits but re-invested to support charitable objectives. These sources of capital can be insufficient to meet a HA's growth objectives as outlined in the previous report Delivering a Step Change in Affordable Housing Supply which estimated that, at best, no more than circa 65,000 homes a year could be delivered by the HA sector, compared to forecast requirements closer to 145,000. Since the report was issued in March 2022, economic conditions have significantly worsened with higher inflation, higher interest rate expectations and rent policy decisions exerting additional pressures on HAs and in doing so, reducing capacity of the HA sector even further.

Partnerships with equity investors offer HAs the possibility of growth beyond the constraints of existing capacity. This is achieved through either enabling growth in operations and development activity, while assets are owned by third parties or by releasing cash from existing assets so it can be reinvested into new social housing.

Growth is attractive both financially and directly in striving to meet charitable objectives:

- Growth of operations means reaching – and helping – more people
- Released cash through asset disposals creates capacity for new investment
- Growth of operations can spread overheads and drive value for money
- Growth of development function can spread development admin costs
- Growth of development function boosts regional presence and access to sites

Fundamentally, for HAs, supporting the development of new social housing homes is directly in line with charitable objectives, and a good thing. And given the existing financial pressures on the not-for-profit sector through building safety and net zero carbon, the partnership model provides avenues for business growth with a variety of potential structures, some of which require minimal capital outlay.

Other potential advantages for a HA may include:

- Cross pollination from other sectors can provide benefits in the form of systems, procedures, risk, governance and strategy.
- For-profit investors accessing new stock through the development of new housing typically come with strong development experience, often in mixed use developments for which affordable housing forms an important part.
- Partnerships with for-profits offer the opportunity to access development resource and economies of scale in the bid/acquisition process.
- Diversification of income exposure away from social housing rent policy and towards management income.

Principal risks for HAs in working with a for-profit partner are: scale, regulation, reputation, financial, and choice of partner. As we shall see below, these are also the principal risks for for-profits.

The for-profit perspective

The Housing and Regeneration Act 2008 was enacted following the Cave review[3], to permit profit-making organisations to be registered with the social housing regulator for the first time, with the aim to increase the supply of affordable providers and homes.

The number of for-profit providers grew slowly in the early years although has grown more rapidly in the last four years. Last year the number of for-profit providers totalled 63, with circa 9,000 homes under management although with far more in development.

While the primary distinction between not-for-profit and for-profit registered providers (RPs) is obvious, it has resulted in a number of more subtle differences, namely:

- Most for-profit RPs are investment vehicles limited by share capital, whose purpose is to often, although not always, to distribute dividends to their shareholders.
- The board of the RP must be independent of the parent structure and must still ensure that the RP is able to continue to discharge its landlord obligations and comply with all regulatory requirements.

The ownership structures are varied, depending on the commercial motivations of the parties, however are all consistent in that the RP must have a substantial interest in the property, which has led to a number of iterations such as; direct ownership, joint venture structures, geared leases, and management leases.

The business case since 2008 has developed into an established financial business model, however, it is useful to summarise some of the key attributes of the asset class to for-profit investors:

- Structural imbalance creating a persistent under-supply of affordable homes, with current waiting lists for social rent properties totalling circa 1.2m for England, equating to a supply requirement totalling 145,000 new homes annually. This will ensure continuing market demand.
- Typically long-term, stable cashflow, with indexation, to provide an inflation hedge; which in turn brings a lower cost of capital to the market.
- Exposure to residential market cycles through house price growth in shared ownership.
- Enables companies typically based in other areas of the market to invest in affordable homes.
- Strong social impact performance by providing much needed affordable housing and the societal benefits of improved well-being, greater sense of community, regeneration, and localised economic development.
- Portfolios can be assembled on a piecemeal basis, not essential that they are acquired in a single block/ development, which reduces business risk.

For many for-profits there are strong attractions to forming partnerships with HAs:

- Access to HAs processes, systems, experience and scale in the management of social housing assets and tenancies.
- The involvement of HAs can add an element of credibility to development schemes, particularly in areas where they have previously delivered affordable housing.
- Access for non-registered investors to operational/development assets, with a regulator compliant management structure in place.
- Investors benefit in the development process from the operational and development experience of RP's, such as informing specification, advising on the sales/lettings processes, assisting with negotiations on nomination agreements, and affordable housing tenure splits.

Principal risks for for-profit RPs working in partnership with HAs are the mirror of those faced by HAs: scale, regulation, reputation, financial and choice of partner.

3 Professor Martin Cave's independent review of social housing regulation published in June 2007

Finding the right partner

The choice of partner will depend on the strategic purpose behind the partnership. Different kinds of partnerships will mean different aspects of potential partners become more or less salient. In the table below we explore different aspects that may be relevant for partnership selection.

These considerations will weigh differently depending on the partnership under consideration. At one extreme a straight disposal of social housing assets by a HA to a for-profit may mean aspects such as scale, financial expectations, track record and financial condition are paramount. At the other extreme a long term partnership with a HA leasing assets from a for-profit might mean aspects such as reputation, change in control, term, ESG and regulatory status come to the fore.

Strategy

Aspect	Comment
Scale	Partners will need to align on the scale of the shared ambition, recognising each contribute something towards each partners' overall strategy. For larger for-profits and not-for-profits economies of scale may push towards larger partnerships, but this will not be the case for all.
Geography	Partners will need to align on target geographies. For reasons both of history and operational efficiency, players in the not-for-profit sector tend to be regionally bounded. For-profits looking to own but not operate assets may not have such a need to cluster investments.
Term	The implications of a short partnership are rather different to those expected to stretch over many years. Alignment between partners anticipated term is central to agreement on contractual terms and the basis of business.
Financial expectations	If financial expectations are not aligned its unlikely a partnership can proceed. As the market for social housing assets is relatively immature, there's uncertainty on all sides over where fair value sits – both for assets and for the cost of operations.
Risk appetite	The corollary of financial expectations is risk appetite. HAs are used to taking the full risk of ownership and management of assets. When HAs partner with for-profits they can expect some of these risks to be taken by the for-profit. Understanding which risks each party is exposed to and ensuring they are compensated for that risk is fundamental.

Terms

Aspect	Comment
Change in control	Partners will need to consider the implications of a change in control. For a HA that would most likely be through merger with another HA. For a for-profit that change in control might come either through shifts in the equity investor base or through sale of assets to a third party.
Exit	Not all partnerships succeed. Alignment over mechanisms to unwind and move on if things don't work out is a vital early discussion between partners.

Partner

Aspect	Comment
Reputation	The reputation of a partner becomes more important the less transactional a partnership is. A good reputation for collaboration and partnership working gives confidence. A partner with a reputation to maintain is more likely to take rational steps to preserve that good reputation.
Financial condition	The more reliant partners are on each other the more important financial condition becomes. Neither partner will want to risk starting a venture which is unduly exposed to risk on the partner being able to deliver on their obligations.
Track record	For HAs, most of whom have a long track record of housing operations and development, the relevant track record may well be on quality of delivery. For for-profits a relevant track record will consider other investments into this and related sectors. On both sides, is there experience of partnerships?
Regulatory status	The Regulator of Social Housing issues grades to providers of social housing. Where these grades imply non-compliance, it can cause potential partners to re-think. Neither for-profit nor HA would wish to be exposed to undue regulatory risk through its partner.
Complementarity	The fundamental driver for partnership is that each of the partners needs something the other has. Where partners bring complimentary experience, skills, assets or approaches to the table it can really cement a partnership and underline its value to either side.
Environmental, Social and Governance (ESG)	ESG reporting and scoring is now a factor in investment decision making, and is increasingly becoming a lens to scrutinise partners and supply chains. Those with weaker ESG metrics or weaker ESG reporting may over time find fewer parties interested in partnering.

Possible models

The nature of partnership working is that each partnership is unique. In the table below we analyse seven broad structures for partnership between HAs and for-profits, noting that within these broad structures there's scope for a wide set of partnership arrangements.

For-profit lets management agreement to HA – In this model the social housing asset is owned by a for-profit registered provider of social housing. The for-profit is responsible for meeting the requirements of the Regulator of Social Housing and outsources day to day operations to a HA in order to leverage their existing expertise and operating platform. A range of management agreement structures exist, each shifting the balance of responsibility for things like major repairs, insurance, reporting etc between the parties. An example of this model is L&G Affordable Homes, which has a patchwork of regional operating contracts let to HAs that covers the whole country.

For-profit leases to HA – In this model the social housing asset is owned by a for-profit registered provider of social housing. The for-profit is responsible for meeting the requirements of the Regulator of Social Housing and leases the property to a HA which is responsible for the day-to-day operation of the homes. As above this allows the HA to leverage its existing expertise and operating platform. In a lease arrangement the HA also manages voids, and bad debts and has more overall control of the homes. An example of this model is Man Group's lease arrangements with Longhurst Group to manage homes across the East Midlands.

Sale of assets by HA to for-profit – In this model the HA effects a clean sale of social housing assets to a for-profit provider of social housing. The for-profit would require regulated status in order to acquire existing social housing assets. To achieve best value the HA would most likely complete the sale between interested parties. Two examples of this are Metropolitan Thames Valley disposing of operational shared ownership homes to RESI in a series of transactions, and Optivo's agreement to sell rented and shared ownership homes currently under construction to Sage upon completion. In both cases the HA will continue to manage the homes. In the Optivo-Sage partnership, Optivo (the HA) has secured the development sites, designed the

homes and neighbourhoods, and is managing both the build and the sales and marketing activity – leveraging existing capabilities and ensuring a product that fits seamless into its operational portfolio, while delivering for Sage a product that draws on the experience and expertise of a long-established operator.

Ownership JV between for-profit and HA
Joint ownership of assets between HA and for-profit investor secures alignment and for the HA, reduces risk of mis-pricing sale to the JV. A possible example of this approach is the disposal of shared ownership assets by Hyde into the M&G Shared Ownership fund, while also acquiring an investment in the fund itself with the proceeds of disposal. Other approaches may see a 50/50 joint venture-specifically set up to either acquire homes from a HA or to collaborate on investment in new homes.

Investor leases to HA, shares risks
While some investors approach the social housing sector through a for-profit registered provider of social housing, others are looking to HAs to hold regulatory responsibility and to sit behind them as asset owners. Within this structure the investor leases the assets to the HA which in turn uses them as social housing. An example of this approach is CBRE Investment Management's long term lease deal with Thrive Homes, in which the partners will share the risk and return of ownership and operation of the homes.

The long leasehold structure allows for the freehold to be traded to other non-registered entities, thereby reducing the barriers for entry to the sector for investors, while still upholding the regulatory requirements and the focus on the occupier. Federated Hermes created a long leasehold structure with Square Roots which, combined with a Management Agreement, apportioned the risk between the parties and aligned interests with respect to returns.

Investor leases to HA, all risks with HA
While leases can allow for risk allocation between parties, until recently the only lease structure used within the sector was one in which all risk sat with the HA. More like a debt-funding of the HA, with the associated accounting implications, the Regulator of Social Housing has raised concern over the use of this model given the inherent inflation link to lease payments.

HA sets up as fund manager
This structure would see HAs' looking to disintermediate the traditional fund management industry and secure mandates to manage funds on behalf of investors directly. We have not as yet seen HAs adopting this model, no doubt in part because of the significant regulatory burden in fund management and economies of scale necessary in that industry, the lack of experience or credibility HAs have as fund managers, and because of the evident conflicts of interests if HAs are looking to control investments into their own existing assets.

The table below considers these six broad structures for partnerships and analysis potential advantages and pitfalls of each.

	FPRP lets Management Agreement to HA	FPRP leases to HA	Sale of assets by HA to FPRP	Ownership JV between HA and FPRP	Investor leases to HA, shares risks	Investor leases to HA – all risks with HA	HA sets up as fund manager
Where does Operating Risk (costs, H&S) sit?	HA	HA	Can be either	Can be either	HA	HA	HA
Where does Income Risk sit?	FPRP	HA	FPRP	JV	Investor	HA	Investors
Where does Social Housing Regulatory Risk sit?	FPRP	FPRP	FPRP	JV	HA	HA	HA
How long might contractual terms be?	Medium	Medium	Short	Long	Medium-Long	Long	Long
Who has most control over the assets?	FPRP	HA	FPRP	Both	Investor	HA	HA
Financial impact for HA	Spread overhead costs	Spread overhead costs	One off cash income, lose future net revenue	One off cash income, lose future net revenue	Spread overhead costs. Perhaps balance sheet impact, depending on lease term.	On balance sheet financial obligation	Incremental income from fund management
Financial Risk for HA	Misprice fee income	Misprice total operating costs	Sell for less than value	Sell for less than value	Misprice fee income	Relative cost of finance	Misprice fund costs / income. Fund set up costs. Fund regulatory risk

A further variable for partners to consider is whether to encompass new, existing or both new and existing social housing assets. Acquisition of existing assets depends on a willing seller, and as things stand there has been little market for HAs disposing of stock at scale to for-profits. This is possibly because of nervousness from HAs around disposing to for-profit registered providers, and possibly nervousness amongst for-profits of investing in older assets.

Acquisition of new social housing will tend to take longer to build and scale, and will rely on... and rely on development-finance until assets are ready for use. Yet development sites and assets under construction are available, and may well continue to be available in the years ahead as HA's own development pipelines reduce in response to headwinds over building safety, net zero, much higher inflation and interest rate expectations and debates over rent increases.

Value

In this new and dynamic market there are relatively few touchpoints for establishing market valuations – certainly far fewer than comparable residential investment sectors such as student accommodation or market-let residential. The traditional approach to social housing valuation used by bank lenders for evaluating the property security in charge to them seems to bear little resemblance to the levels either HAs or for-profits have been investing at.

Portfolios of social housing assets do change hands between providers of social housing, though with relatively little transparency on price. As such, it is difficult to understand the details of a transaction and break metrics back to specific tenures. There are also typically idiosyncratic reasons - stock rationalisation or densification strategies – which mean these transactions may not truly reflect the wider affordable market.

Whilst a discounted cashflow (aka existing use value – social hosing) approach is standard market practice amongst independent valuers, an income and yield approach better supports benchmarking values in an attempt to analyse trends in the market. As this market matures we hope to see independent valuers offer greater transparency of the net initial yield profile for different tenures and portfolio types within the social housing space. This will aide partners in their decision making over the kinds of partnership to pursue.

As a requirement of charity law it's imperative HA's selling assets achieve value for money. Some HAs have been able to get comfortable with on sale prices on the basis of independent valuations. Others have achieved the level of comfort they need through a tender process. Either way, valuation is a separate point to consideration, and we do expect over time more HAs to accept payment or part-payment for assets through a direct stake in an a for-profit registered provider.

Over time we also anticipate development of a common industry-wide understanding of the levels at which for-profit investors might acquire assets. This transparency will help HAs come to a judgement on the relative merit of disposal or retention of existing social housing assets, speeding up decision making. Ultimately the onus is on Boards to ensure sound governance and risk awareness as deals are entered into.

Unlocking partnerships

There are a wide range of discussions on potential partnerships underway, covering the full range of broad partnership structures as described in this toolkit. To really speed up the rate of partnership formation – and therefore of investment into the social housing sector – there are several things that may be helpful.

1. Greater clarity from valuers over indicative yields at which various social housing tenures are acquired by for-profits, to aid partners in gauging whether disposals / acquisitions are appropriate for them.

2. More standardisation of management agreements for the management of social housing by HAs for for-profits, to speed up and simplify the process of putting these agreements in place.

3. A code of governance for for-profits, along the lines of the existing code for HAs, to build HA's confidence in for-profit registered providers as partners.

4. Faster approvals for establishing new for-profit providers of social housing, to lower the time and cost barrier to entry into the sector and to speed up deployment of capital.

5. Resolution, or at least clarification, of the different tax and grant treatment faced by HAs and for-profits.

Even without these changes, however, we seem set to see a growth in the number, the scale, and the diversity of these partnerships.

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