INSIGHTS

UK AFFORDABLE HOUSING
"STABILITY IN UNCERTAIN TIMES"

SEPTEMBER 2020

The case for investing in UK affordable housing is underpinned by a long-term demand supply imbalance. This was the case before the coronavirus outbreak and will continue to be the case long after the disruption caused by the outbreak has passed. However, the sector also offers certain investment characteristics that are particularly desirable, and scarce, during periods of economic disruption.

STABLE INCOME

Affordable housing rents are paid by a combination of households and government, and the sector operates within a well-defined system of regulation and governance. Registered Providers (RPs) of social housing are usually Local Authorities or Housing Associations, which are regulated and receive funding from the Ministry of Housing, Communities and Local Government (MHCLG). Private investors typically let assets to these RPs on a long lease, often 20 years plus, and the regulated nature of the sector means that the income comes with implicit government backing which makes it one of the most stable, consistent income streams in the real estate sector.

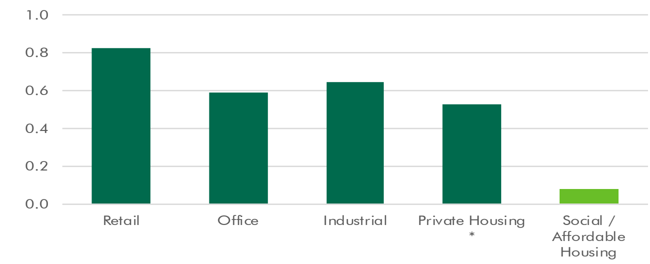
HIGH OCCUPANCY RATES & LOW TENANT TURNOVER

Stability also comes from the robust fundamentals. The sector benefits from occupancy rates that are consistently very high, with demand outstripping supply and tenant churn rates relatively low. To qualify for affordable housing, a tenant needs to be on a Local Authority waiting list, and once in occupation if a tenant voluntarily vacates then they do not then qualify to go back on the Local Authority list, and they would need to find accommodation in the private market. This means that tenant stays are significantly longer (typically 5 years or in some cases a lifetime) than in the private housing market, hence maintaining a consistent income stream.

INDEX-TRACKING INCOME GROWTH

Since the sector is regulated rental growth is set by government policy. Hence, while underpinned by the 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.

FIGURE 1: Rents correlations with GDP Growth, 1998-2018



Sources: MSCI, DCLG, ONS, CBRE Global Investors.
*private housing rents data starts in 2006.

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 ten years). This means that future rental levels are far more predictable than if they were set in the open market. In 2017 the government confirmed that increases in social housing rents will be set at CPI plus 1% for 5 years from 2020. We expect rental growth beyond 2025 to track CPI inflation at 2% p.a. over the long run.

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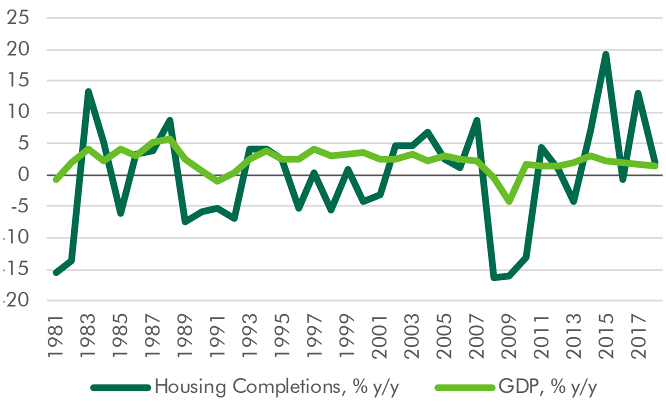
STABLE AND PREDICTABLE CAPITAL VALUES

Affordable housing capital values are also not driven by the same market forces that influence house prices in the private market. Instead valuations are driven by the rental stream achievable from the asset, and since the income is stable and predictable, value growth is far less volatile than in the private residential market or commercial real estate. As rents are indexed, capital appreciation is created in line with steady increase in rental income and values are insulated against market downturns which affect private housing. The sector also has favourable residual value dynamics as the rate of asset obsolescence is slow compared to the commercial property sectors.

RESILIENT TO ECONOMIC SHOCKS

Unlike other property sectors, affordable housing rents are not correlated with economic growth 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. Since rents are also uncorrelated with commercial property rents, affordable housing is even more effective in providing diversification to a commercial property portfolio than private residential.

FIGURE 2: GDP Growth & Housing Completions, % y/y



Sources: ONS, Oxford Economics.

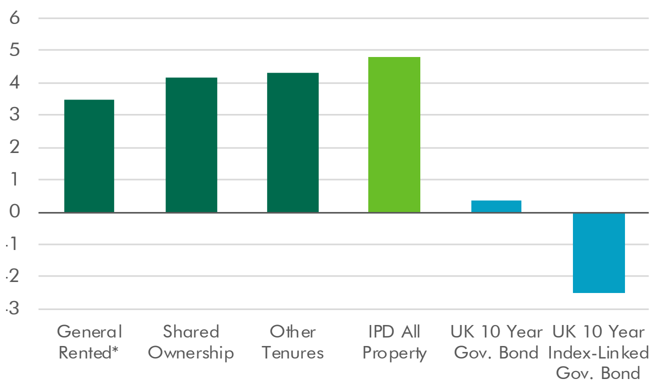
Further countercyclical support comes from the fact that housebuilding has historically been curtailed during economic downturns, which has led to less affordable housing delivery. Meanwhile, the number of households eligible for and requiring affordable housing is likely to rise in these periods. This provides a countercyclical support to the sector.

ATTRACTIVE YIELDS FOR STABLE IMPLICITLY INDEX-TRACKED INCOME

We estimate a combination of affordable housing types (weighted 50% general rented, 25% shared ownership, 25% other tenues) can currently achieve a blended yield of 3.9% This represents a 350 bps spread to the 10-year UK government bonds, or a 640 bps spread to 10-year index-linked government bond yields. The latter is the more appropriate comparison since the majority of affordable housing rents are backed or supported by the UK Government, on long term leases with rents subject to annual increases linked to RPI or CPI on a 'uncapped' basis.

In an alternative comparison, the blended affordable housing yield is only 90 bps below the IPD 'All Property' initial yield, despite 'All Property' being subject to market volatility, open market rentals and considerably shorter lease lengths. As such affordable housing offers a very attractive yield given the degree of security being provided.

FIGURE 3: Affordable Housing Yields in Context, Q1 2020, %



Sources: Refinitive, MSCI, CBRE Global Investors.
*General rented includes social and affordable rented.

CONCLUSION

The persistent demand-supply mismatch in the UK housing market which underpins long-term investment in affordable housing is well understood. However, the specific investment characteristics that make returns from the sector particularly stable and resilient are often overlooked.

The sector provides stable, predictable income predominantly supported by the UK government, and implicitly index-tracking rental growth. These characteristics result in an attractive risk-adjusted return profile, which will prove resilient even through difficult economic conditions.

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