UK Affordable Housing - Spring 2023

SPOTLIGHT
Savills Research

Private Capital and Affordable Housing

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FPRP survey results ● Policy and market context ● Partnerships ● State of the market

A continued evolution

Equity investment in affordable housing has continued to grow despite the challenging market backdrop over the last year

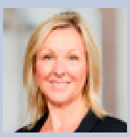
This year's survey results reflects a market in transition. We see growing appetite from Housing Associations (HAs) to partner with investors/FPRPs, as business plan pressures continue to drive the need for new capital. This drive for capital is also seen in an increase in planned sales of stabilised mixed tenure tenanted portfolios, and Shared Ownership stock.

While some FPRP investors paused or slowed acquisitions in the wake of increasing debt costs/market volatility, with pricing moving out accordingly, sentiment is improving and we expect to see pricing and capacity improve during the second half of 2023.

Our pipeline of FPRP registrations shows continued investor/developer demand to access the sector, and this reflects wider investor sentiment and appetite for the Living Sectors as noted in our latest European Living Investor Sentiment Survey.

There remains over 1 million households on housing waiting lists unable to afford soaring private rents or access home ownership. Demand for Shared Ownership is at record levels, following the withdrawal of Help to Buy, providing buyers a secure alternative to private renting, for households unable to afford market housing for sale.

As HA capacity for development is constrained, the need for investor FPRP capital is high, if the supply of much needed new housing is to be maintained. Stability of policy, particularly of rent policy, grant funding, and section 106 supply routes, is vital to underpin investor confidence.



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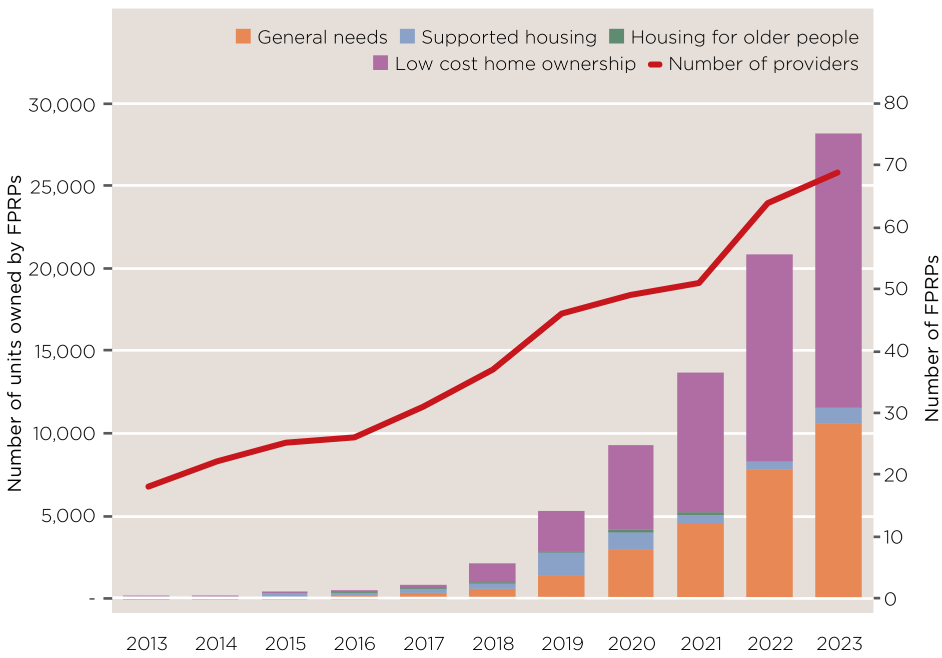
For Profit Registered Providers (FPRPs) now own more than 28,150 affordable homes, according to our latest analysis. This represents growth of 35% since March 2022. The number of homes in the sector has more than doubled since March 2021, driven by a 131% increase in the number of general needs rented homes owned by FPRPs.

As a proportion of all affordable housing, FPRPs own a small proportion of stock, comprising 0.7% of total affordable stock in 2021/22. However, this has been steadily increasing in recent years as FPRPs have increased their share of the market by three times in the three years to 2021-22.

Growth in FPRP registrations and stock



Source: Savills Research, Regulator of Social Housing

The number of FPRPs has continued to expand albeit at a slower rate than previous years. Over the last year, there were six new FPRP registrations and one de-registration, taking the total number of FPRPs to 69. This follows a record year of 13 FPRP registrations to March 2022.

Five of the six new entrants this year are backed by developers wanting to retain greater control of the Section 106 homes they deliver, including Delancey's T3 Residential and London Square's Square Roots.

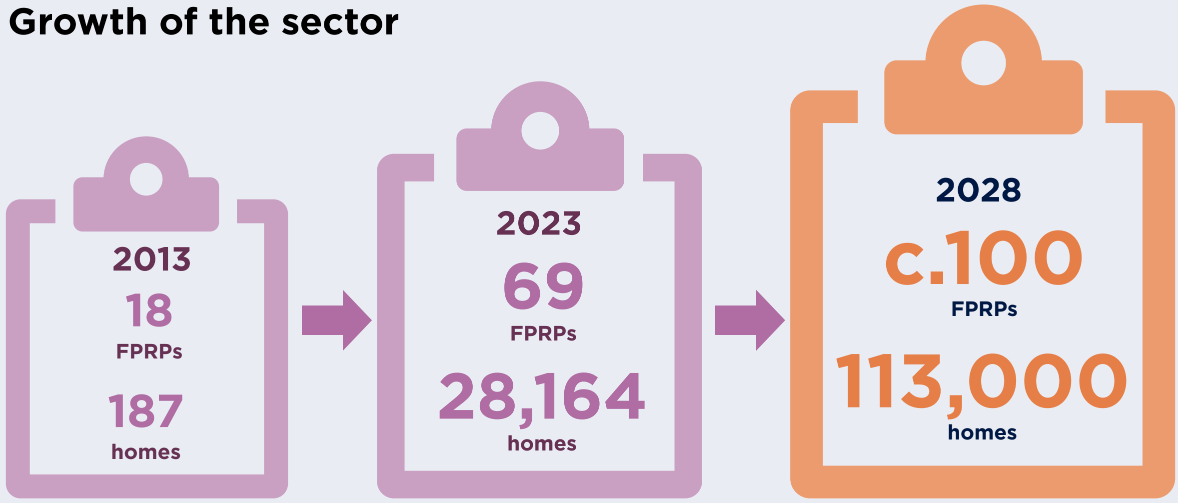
The stock owned by FPRPs remains concentrated amongst a few major players – the three largest FPRPs own 77% of total FPRP stock. However, this is set to change, as existing players look to build their pipelines and new providers enter the space over the next five years. By 2028, we expect the three current largest players to own 56% of stock.

Our survey says...

Our annual survey of FPRP's current stock and future growth ambitions reveals that investor appetite for affordable homes remains substantial. FPRPs are forecasting that they'll own a further 9,300 homes by the end of 2023, taking total FPRP stock to almost 37,500 homes.

In the short term, the rising cost of capital and sticky inflation may act as a constraint to future growth of existing FPRPs. But we do expect to see greater levels of activity from new entrants over the next five years taking the total number of homes owned by FPRPs to c.113,000 in 2028.

Growth of the sector



Source: Savills Research

Profile of FPRP stock

To date, FPRPs have most commonly grown their pipeline by buying Section 106 stock from developers and through grant-funded development. The greatest appetite amongst FPRPs remains for newer, more energy efficient stock but there is growing interest in acquiring older legacy stock too. This will become important as Housing Associations (HAs) increasingly seek to recycle capital from stock sales to fund development and investment. There are examples of some providers such as Places for People Capital who prefer to develop homes themselves in order to embed ESG and limit any future retrofitting requirements. Places for People Capital is currently the only investment management fund that is a subsidiary of a HA. Looking ahead, we may see more HAs follow this type of model in time.

Shared Ownership remains a key focus for FPRPs. It makes up 59% of total FPRP stock now and is projected to be 63% in five years' time. Some investors focus exclusively on Shared Ownership, because it offers both a steady stream of rental income and some exposure to house price inflation through staircasing.

Shared Ownership also requires minimal management when compared to Social and Affordable rented stock. It also fills an important niche in the housing market – housing those unable to access social housing for rent, and priced out of market housing for sale. However, rented stock is also of interest, given the structural undersupply and contribution to meeting housing need this tenure offers.

Future prospects

Despite the current challenges in the economy, the long-term fundamentals of the sector remain robust. A persistent undersupply of new homes and near record house prices relative to incomes will ensure strong demand for more affordable homes continues. And the growing importance of responsible corporate governance is driving increasing investor interest in the sector, with several major FPRPs listing this as the most important factor in their decision to invest in affordable housing.

It is likely that the investor market will become increasingly diverse over the next five years and beyond. 90% of FPRPs are looking to hold stock over the long term and have no plans to exit the sector in the next 20 years.

Smaller players are also planning to scale up and increase market share. There are also currently c.30 applications for registration in the process of being completed, which will drive further growth in the sector.

The potential for partnerships is also growing with HAs facing rising constraints on their financial capacity and pressure to invest heavily in existing stock, coupled with shifting attitudes and much more willingness to engage with FPRPs and find innovative solutions to continue to deliver development. There is also scope for FPRPs to help fund large-scale decarbonisation and net zero programmes across the sector.

The perfect storm

Why bringing new sources of finance into the affordable housing sector has become ever more important

The rising cost of finance, the introduction of a cap on rent increases and high inflation has put traditional HA budgets under increased pressure. Whilst the counter cyclical delivery model has been critical to maintaining housing supply in previous downturns, constrained financial capacity means that HAs are unlikely to be able to deliver at higher volumes over the next five years. However, this does present more opportunities for FPRPs and investors to build their development programmes, particularly through the increased use of partnerships.

Shifting sector priorities

Many HAs are having to make difficult choices in how to allocate their spending going forward. 95% of respondents to our survey said that investment in existing homes and communities is more important to them than the development of new homes.

This is in sharp contrast to a survey we conducted in 2019, where just 41% of HAs prioritised existing homes. This marks the shift in the sector towards quality of service and customer satisfaction through management of existing stock. As a result, the ability and appetite of traditional providers to invest in new homes is restricted.

49% of HAs surveyed are planning to cut back on their development programme in order to pay for building safety and decarbonisation works, up from just 30% in 2021. Of these, 35% will cut more than a quarter of their development programme.

Financial strain on the sector

Since 2020, the sector's financial capacity has been increasingly constrained. Multiple factors such as the Covid-19 pandemic and the war in Ukraine gave way to build cost inflation, labour shortages, an economic downturn, rising levels of inflation and a real terms rent cut. The rising cost of debt is also proving costly for those providers who have had to renegotiate debt arrangements.

On top of this, HAs have seen significant increases in spending levels on existing stock as a result of increasing standards on fire and building safety, a renewed Decent Homes Standard and decarbonisation targets. HAs spent a record £6.5 billion on existing stock in the year to March 2022, a 20% increase on the previous year. Concerns around stock quality have been further compounded by recent high-profile issues surrounding damp and mould.

Sector spend on existing stock is set to continue to increase with projections for a further £40.7 billion on repairs and maintenance over the next five years according to the 2022 Global Accounts published by the Regulator of Social Housing. In particular, large scale investment is required in order to decarbonise HA stock. In 2020, Savills estimated that it would cost £35.8 billion for homes across the sector to achieve the minimum target of EPC Band C rating by 2030.

In recent years, HAs have been able to offset these rising costs by raising rents at a rate of CPI + 1% per year, in this case 11.1% from April 2023. But from 2023/24, Government has set out that increases in social and affordable rents will be subject to a mandatory maximum increase of 7%, in a bid to help tenants given the wider cost of living crisis. This cap on rent increases will cost HAs between £400m and £1.2bn in lost revenue. Some HAs are also implementing a voluntary 7% cap on Shared Ownership rents.

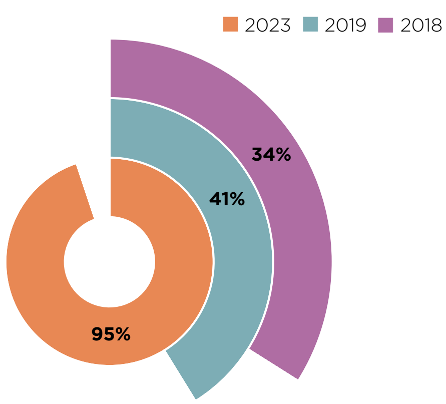
Counter cyclical housing delivery

In recent months, the rising cost of debt, build cost inflation, falling house prices and the end of the Help to Buy scheme have led a slowdown in the new build market. Declining sales activity has also fed through into reduced private housebuilding starts.

Historically, HAs have played a key role in delivering homes during wider development market downturns, being responsible for 43% of all new homes delivered in 2010/11 following the Global Financial Crisis (GFC).

A renewed focus on existing stock

Proportion of HAs who think investment in existing stock should be prioritised over the development of new stock



Source: Savills Research

Given the end of the Help to Buy scheme, Shared Ownership has a key role to play in helping fill the gap in the new build market, aligning well with the preferred tenure of FPRP investors. Demand for Shared Ownership is anticipated to be strong in the medium term as first time buyers, facing rising mortgage rates and ongoing rental increases in the private rented sector, seek affordable home ownership options post Help to Buy.

Role of grant funding

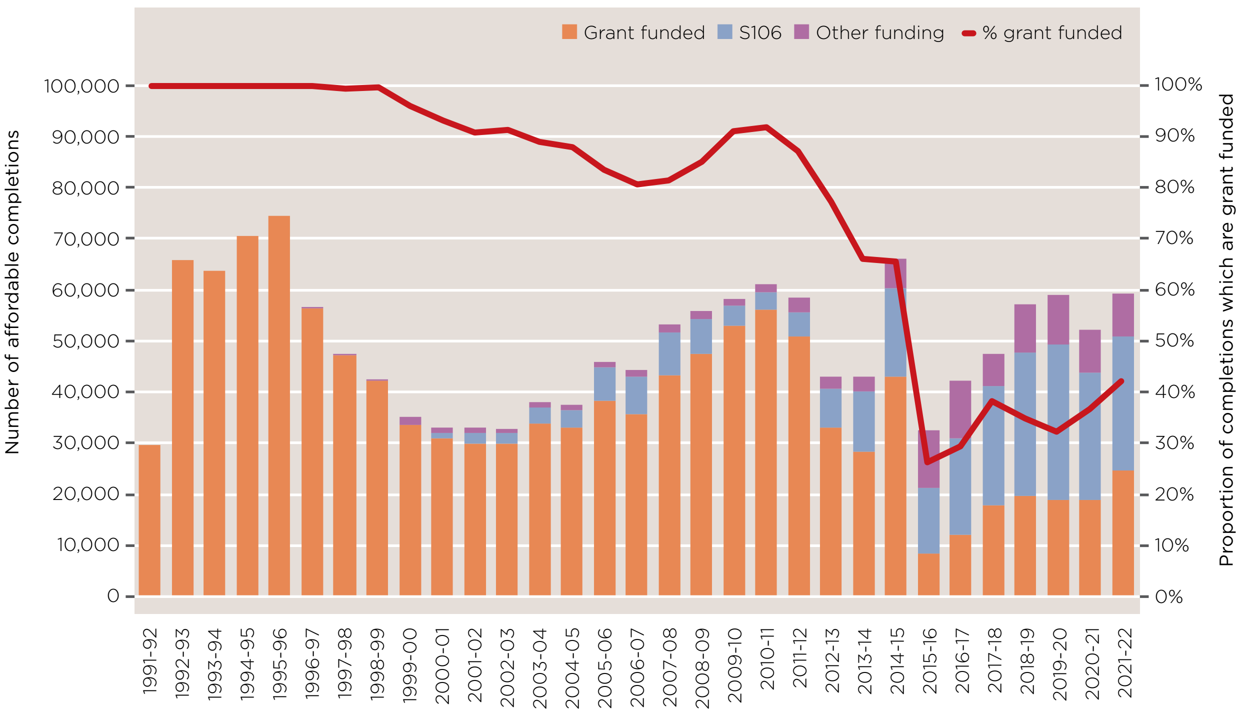
Greater funding for the sector will be needed if HAs are to grow their share of overall housing delivery in addition to the large-scale requirements for existing stock. The Government has already allocated more generous grant funding in the 2021-26 Affordable Homes Programme at an average of £64,000 per unit. In 2021-22, grant funding accounted for 42% of affordable completions, the highest level since 2014-15. But with overall housing delivery expected to fall in the medium term, the supply of affordable homes through Section 106 will decrease. HAs are also finding that their grant funding doesn't stretch as far in a high inflation, high interest rate environment.

In a bid to help keep the market moving in a weaker new build sales market no longer supported by Help to Buy, Homes England has recently announced that HAs can now use grant on completed homes originally built for market sale.

This will give developers more certainty to continue to build homes as they are able to mitigate risk through diversifying the tenure offering on larger sites.

Providing more Social Rent homes is a priority for the Affordable Homes Programme, in line with where there is the greatest need for affordable housing. There also remains significant potential for more affordable rented and intermediate housing options for older people which could be unlocked with the right policy support.

Affordable completions by type of funding



Source: DLUHC

Stabilised and legacy stock market

The market for sales of stabilised social housing remains active as landlords continue to rationalise their operating footprint for greater efficiency. The Shared Ownership market is on the verge of opening up, as appetite from HA's to sell at scale gathers pace. We expect a corresponding increase in demand from FPRPs and investors to build Shared Ownership portfolios, as pricing aligns.
Other notable trends include sales by general needs landlords of stabilised retirement, extra care and supported housing portfolios, as they seek to focus on maintaining core assets, with growing pressures on energy and sustainability standards.

HAs are becoming a lot more comfortable and willing to engage in partnerships with FPRPs. Partnerships and collaboration will be key to ensuring future growth of the sector.

From competition to collaboration

Shifting sentiment has coincided with constrained sector financial capacity leading to more potential for partnerships and collaboration

Housing Associations increasingly face greater internal pressure to find alternative sources of investment. This has coincided with a shift in attitudes towards FPRPs and their motives away from perceptions of FPRPs as competition in the market. Even more important is the increasing recognition of the role of equity investment in unlocking financial capacity in the sector.

After years of reticence, HAs are becoming a lot more comfortable with, and willing to engage in partnerships with FPRPs. Looking ahead, collaboration between HAs and FPRPs will be key to ensuring future growth of the sector.

In 2019, a Savills survey found that just 62% of HAs thought that FPRPs had any part to play in solving the housing crisis. But our survey this year found that 89% would now consider some form of partnership with a FPRP, highlighting the evolution of attitudes.

Partnerships between FPRPs and HAs are beneficial for both sides. FPRPs have significant volumes of capital to deploy and seek strong ESG characteristics but lack operational and development capabilities.

On the other hand, HAs have the in-house operational and management expertise but require access to investment capital to invest in existing stock whilst maintaining their development programmes. There is an increasing appreciation of the differences between FPRPs and HAs in how they operate. Partnerships also present a great opportunity to share best practice across the affordable housing sector and other living sectors.

Preference for partnerships

89% of HAs would consider partnerships with FPRPs

43% of HAs are already partnering with a FPRP in some capacity

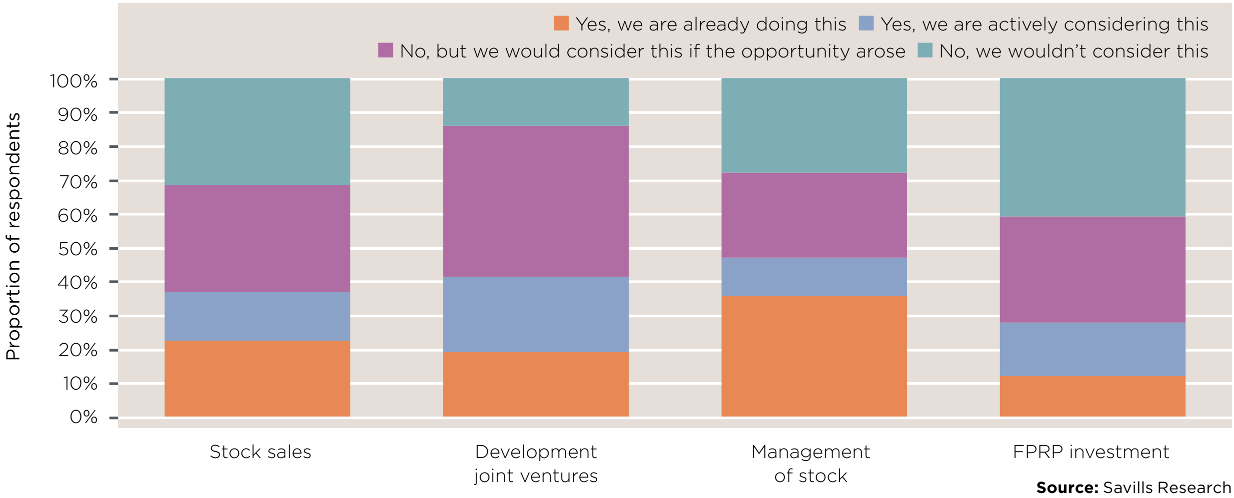
90% of FPRPs are either already working with a HA or are actively considering working with a HA

70% of FPRPs are already engaged in stock management arrangements with HAs

With so much potential for partnerships to deliver affordable housing, the question becomes how best to target FPRP investment in the sector. In addition to greater appetite for collaboration, there is also a growing understanding of the different types of FPRP structures and partnerships. The most popular form of partnership is development joint ventures, which 85% of respondents would consider, while more than 70% would consider stock management arrangements. These are also the most popular partnership arrangements among FPRPs, with 70% of FPRPs surveyed already engaged in stock management deals with HAs.

Several HAs we surveyed either already have or are considering setting up an in-house FPRP to help fund their development ambitions. Being able to take on equity investment will open up a different pool of capital, particularly advantageous now that debt is more expensive. AXA have recently taken a 50% stake in Hyde Group's FPRP Halesworth, for example, which will unlock up to £400m of development finance for the group over the next decade.

Are you considering the following arrangements with For-Profit Registered Providers?



Source: Savills Research

Strong investor appetite

Whilst the not for profit space has been focused on existing assets over the last 12 months, the FPRP space has seen a varied backdrop. We have seen strong growth from existing FPRPs but we have also had mixed feedback from potential new entrants noting the market backdrop.

Whilst there is strong support for the sector, there are fundamental challenges particularly as real yields on social housing haven't repriced vs 2021 levels. There is also uncertainty in terms of inflation including the cap on rent increases and also the relatively high set up and operational costs in running a Registered Provider. There still remains strong appetite from investors to enter into the sector and establish FPRPs and demand for debt to leverage established structures although the market isn't as strong as it was 12 months ago. The market volatility will be key to track with the stabilisation of real yields and more 'normalised' market conditions as potential catalysts to promote more new entrants to consider setting up FPRPs.

The development market

Whilst there continues to be appetite to grow amongst FPRPs and some traditional HAs, there has been an obvious flight to quality with the most attractive opportunities continuing to receive strong interest.

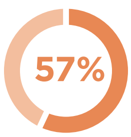
Looking ahead, in the short term, there is somewhat of an uneven playing field between traditional HAs of which many have raised significant fixed interest capital in a lower interest rate environment and FPRPs who have been more responsive to changing interest rates, resulting in offers in some cases being less competitive.

However, this is likely to adjust over the next 12 to 18 months as HAs begin new capital raises which will bring their pricing more in line with FPRPs. Further hikes in interest rates may impact FPRP competitiveness in the short term but the increase in the cost of traditional HA debt will lead to a more even playing field across bidders from late 2023/ early 2024 onwards.

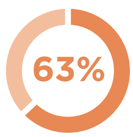
Responsible investment

More investors are looking towards the affordable housing sector as firms look to meet ESG goals and engage in responsible investment. But investors do still demand a return on their investments. Our survey of investors into affordable housing found that the long-term stable income that affordable housing offers is the most important factor attracting capital to the sector. More than 70% of respondents said this was their key motivation. More than half ranked ESG credentials as the second most important factor.

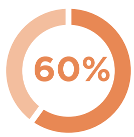
A separate Savills survey of investors into the Living sectors across Europe found that favourable demand/supply characteristics and ESG were the most important drivers of more general investment in the living sector. Affordable housing therefore remains a very attractive investment product for a large number of investors, providing a secure, steady stream of rental income and contributing significant social value and impact.



of investors say ESG is very important, a further 29% say it is important



say favourable demand/supply dynamics are very important



say social value and impact is very relevant for them, with a further 31% saying it is somewhat relevant

Savills Research
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