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Homes for investors

Real Estate sector

UK residential REITs: the start of a journey

Until 2016, the only meaningful way to invest in listed housing was Grainger Trust or specialist student funds. Since November 2016, with Civitas Social Housing floating its over-subscribed REIT, £1,282m has been raised via four REITs. These REITs capture sustainable, growing income streams, supporting dividend yields of 5% or more, when floated. This income is a by-product of the real and ongoing need for new housing stock. We assess some of the detailed risks and opportunities that both REITs and their investors have to navigate. We include Build to Rent (BTR) sector opportunities, particularly for two quoted developers, and the PRS REIT.

- **REIT Strategy:** Many of these REITs are truly infrastructure investors. Housing Associations (HAs) seek capital for new home building and have already taken on debt. To bring new capital to the asset class, they provide new investors with long and secure lease income-streams.
- **Investment case:** Several £bn of social housing is to be sold in coming years: £1bn projected from one HA merger alone. Care providers are selling too. Existing REITs have demonstrated these assets can be purchased (and new-build being forward-funded) and packaged on terms attractive to both parties.
- **Large, growing markets:** UK home-owner occupation peaked in 2007. Open market rental and social housing is growing. The latter stock alone is valued at over £300bn, putting the £1.28bn raised so far by the REITs in context. Other opportunities, such as BTR also offer fertile investment opportunities, and should be seen as a catalyst to unlocking large mixed-use strategic sites, adding significant value which can be shared by developers, investors and tenants.
- **Attractive and predictable historic returns:** Investability problems around low net yields are now fully resolved by the new REIT lease structures, which support good (5% plus, growing with CPI+) dividend streams.
- **Execution risks:** Asset yields are strong (mostly over 5% net initial yield) but in some segments, growth and values at end-lease need exploring. Not overpaying, during this upsurge of money invested, is important: but crucially and supportively, the target sectors are very large. Income security is high.
- **Operational risks:** Occupancy risks and end-lease valuation risks are important considerations. Long-term interest rate rises might become a valuation issue. Separately, BTR developers should face a steady, substantial, specialist demand. But this is a new market with little UK track record; in the US, c20% of stock is private build-to-rent.

We assess REIT investments as well as the developers, TEF and WJG

REIT Financial summary and valuation

REIT	Raise	IPO date	Price (p)	NAV (p)
Civitas Social Housing (CSH)	£652m	Nov 16	110	110
Empiric Student (ESP)	£605m	June 14	89	106
GCP Student Living (DIGS)	£485m	May 13	142	139
LXi (LXI)	£200m	Feb 17	104	99
The PRS REIT (PRSR)	£250m	May 17	103	98
Residential Secure Income (RESI)	£180m	July 17	100	98
Triple Point Social Housing (SOHO)	£200m	Aug 17	103	98

Source: Hardman & Co Research, REITs data

REITs and stocks in this document

Company	Ticker
AEW Long Lease www.aewukllreit.com 020 70164880	AEWL
Civitas Social Housing www.civitassocialhousing.com 020 37094624	CSH
Empiric Student www.empiric.co.uk 020 38288700	ESP
GCP Student Living www.graviscapital.com 020 75181490	DIGS
LXi www.lxireit.com 020 71951400	LXI
The PRS REIT www.theprsreit.com 0333 9999926	PRSR
Residential Secure Income www.resi-reit.com 020 73820900	RESI
Telford Homes www.telfordhomes.london 0199 2809800	TEF
Triple Point Social Housing www.triplepoint.co.uk 020 72018989	SOHO
Watkin Jones www.watkinjonesplc.com 0124 8362516	WJG

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Executive Summary

Strong demand for the fresh capital

There is demand for additional housing in the UK. Much of the debate also concerns need for social housing. Private sector housebuilders are a solution of sorts but many of the largest concentrate – quite reasonably – on maximising return on equity rather than sales. The second largest cohort of developers are Housing Associations (HAs), which are non-dividend entities, reinvesting profits into housing. However, their recent expansion (and other issues such as rent caps) resulted in that sector's loan to capital ratios rising from 40% in 2006 to 48% in 2016 (source: HCA). Fresh capital is urgently required.

Housing Associations are a mainstay of UK housing provision but their debt has risen.....

To supplement existing players, 'patient capital' is being brought in, in the form of REITs which target 5% up to 6% dividend yields (once fully invested, on the IPO pricing) growing in line with inflation. This is made possible in various ways explored in this document but a major driver, we consider, is the desire and the ability of HAs (encouraged by the Government) to put together either long leases or forward funding opportunities to bring this fresh capital into the equation. This began in November 2016 with the Civitas Social Housing REIT.

... they thus encourage new money in, by long leases at returns which prove attractive and – crucially – sustainable at risks we consider modest

Much of the emphasis is on residential assets which should be seen as social infrastructure. REITs such as RESI and PRSR (the latter to a lesser extent) do have meaningful exposure to 'mainstream' UK housing price movements but the assets that others invest in have income streams based on long leases rising with a measure of CPI or RPI inflation. These income streams, with good covenant backing and tending to have minimised exposure to voids, would be seen as secure streams derived from social infrastructure assets. These REITs have little in common with larger established UK REITs such as BLND, HMSO, INTU, SGRO etc.

Social infrastructure assets and income streams

We outline, above, how a significant driver is the ongoing desire, but waning financial ability, for HAs to expand residential stock. The other side of the equation is the twofold drive from investors. Many seek secure attractive income streams and liquidity. REIT structures are liquid without requiring assets to be disposed of (or acquired) to provide that liquidity. Well over £10bn (likely over £20bn) of property investment assets remain in open-ended funds. These have demonstrated major liquidity problems and we note an outflow from these vehicles commencing.

Plenty of scope for expansion of the residential REIT sector

With £300bn+ of social housing assets in the UK, this sector alone provides more than enough potential for investment pipelines (added to which there is strong motivation to grow the quantum of such stock). Comparing purpose built student accommodation, the quoted sector here comprises circa 5% of the total stock of assets. On that basis, invested capital in social housing alone could rise 20 fold from here (including the identified pipeline of assets being purchased). Forward funding of new assets development is a major part of many of the REITs' business models.

Investment is not without risks and hurdles, which we analyse in this document. Some, like the low yield on mainstream housing, have been overcome by the new rental and maintenance structures the REITs benefit from. Others are ongoing – but manageable – risks. REITs are based on financial gearing; they inevitably must take care assessing asset values post the end of the leases, no matter how long the leases.

So far, few of the new REITs invest in private sector 'build-to-rent' assets. We assess the potential here and find it to have the scope for large expansion, with global flows of funds now commencing in real size. This is the precursor to a major asset class.

The capital raised by the four residential REITs to date is 0.023% of the value of all UK housing. This ultra-large market can absorb significant capital, fruitfully

As a comparator, student REITs represent some 5% of the value of purpose-built student accommodation

Typically 5% dividend yields on offer – PRS targets 6%

Turning to the residential REIT sector, we cover the four largest, pure residential REITs. We also cover two build to rent developers. Furthermore, we touch on the three student REITs and three other REITs either partly invested in the sector or (AEWL) with a model illustrating the trend for investors to seek 'emerging' asset classes.

With just under £1.3bn of assets raised so far in residential REITs (non-student), we consider this a truly 'emerging' sector, with plenty of medium-term scope to grow significantly, where assets are available which have exposure to 'mainstream' UK residential risk reward and, conversely, with other assets being available on long - term, high covenant leases providing 'infrastructure style' long income streams.

In summary on the sector, these are ultra-large markets. Housing is worth some £6 trillion but social housing alone is valued at £300+ bn. REITs in non-student accommodation have a total market value of £1,350m which is c0.023% of the value of total UK residential assets or 0.45% of the value of social housing alone. This contrasts with the three student accommodation REITs representing c5% of the value of the total UK purpose-built student accommodation asset class. With willing vendors of assets / creators of new assets and with dividend yields of over 5% appearing sustainable, this is an attractive sector. Hardman has therefore met with or undertaken in-depth one-on-one interviews with all the residential-based REITs.

We summarise our conclusions on the four main UK residential REITs:

Civitas Social Housing has raised £652m, and its primary focus is on 'supported social housing', which is where tenants require assistance and secure tenancies, usually with care workers involved. Civitas has demonstrated that the type of housing it owns improves outcomes and thus cuts costs (for care worker utilisation). The sector is very specialised, thus a focused owner can add real value through the dialogue and expertise it has with its stakeholders. This forms a barrier to wide, price-based competition, so the 5.5-6.5% net initial yields on which it acquires properties are more a function of this required expertise than anything else. Leases are 20 year + and rising CPI +.

The PRS REIT raised £250m. Unlike the other REITs, this is focused on fully open-market stock. Houses for families are the remit and rents are kept affordable by stock being acquired which benefit from discounts available from partner developers to PRS REIT. Prior to the REIT, the Manager had facilitated the development of 3,500 homes in this way, so the sustainability of the model is partly proven.

Triple Point Social Housing raised £200m. The focus here is also on supported social housing, with the managers having extensive contacts and business track record with Local Authorities in asset-backed sectors including housing.

Residential Secure income REIT raised £180m, with shared ownership housing as the larger segment of capital deployment. Shared ownership would be more likely to appreciate with the broader housing market. We reproduce data (page 15) that residential assets have an attractive track record both in absolute returns but also show lower volatility than other commercial real estate (over the past 10 years, i.e. from the previous peak). These assets, though, do have lower rental yields.

Risks and definitions

What are REITs?

From 2007 in the UK

Many of the UK's largest listed property companies are REITs, including British Land, Land Securities, Hammerson, Liberty International, SEGRO and Great Portland Estates. Since the 2007 legislation, most larger UK real estate companies have hanged to REITs.

REITs started life in the US in 1960 when President Eisenhower signed into law the REIT Act. The UK regime launched on 1st January 2007. REITS are publicly-listed (a three-year grace period from formation) real estate companies, investing in physical property, typically retail, industry or office real estate. Up to 25% of profits and assets can arise from 'residual activities' such as development, allowing – to a controlled extent – a mix of risk. A threshold is in place, aiming to distinguish between trading for a profit and the normal development of an investment asset. A tax charge will apply if a distribution is paid to a company or entity that is either beneficially entitled (directly or indirectly) to 10% or more of the dividends paid.

Because of their status as listed companies, REITs leave the investor exposed to stock price volatility. For companies, the main attraction of REIT status is tax efficiency; they pay no Corporation Tax nor Capital Gains Tax - these liabilities are passed on to the investor who pays tax on the proceeds he or she receives in the form of share dividends. They do pay Stamp Duty on assets purchased. In exchange, they are required to distribute 90 per cent of their cash flow, or rental yields, as dividends to investors. REITs can also make money through developing properties.

The interest cover test is 1.25x finance costs, which - unless the effective rate of interest paid by a highly geared REIT were to be much greater than today's rates - is not too onerous, unless the underlying assets are low yielding *after all costs*.

Risks

The REIT sector has a high 'beta' – these REIT stocks should have a low beta

For each individual REIT, we list below some of the risks attached to investment. Notwithstanding the positive background to the current residential REITs, investment in real estate has often proven to be more volatile than equities. They weathered the 2008 financial crisis poorly. In small measure, this was a result of the shares moving from a premium to NAV to a discount to NAV, dividend pay-out constraints and concerns stemming from the assets' performances.

Capital returns rebased 100 end 2005

	REITs	FTSE All Share
Dec 2005	100	100
Dec 2006	140	108
Dec 2007	85	100
Dec 2008	45	65
Dec 2009	50	95
Dec 2010	50	100
Dec 2011	45	100

Note: Income NOT reinvested *Source: Hardman & Co*

But THIS sector is primarily infrastructure style income. We consider few (RESI and, to a lesser extent, PRSR) are exposed to mainstream house price changes

The chart on page 15 illustrates the lower volatility over the past ten years from many classes of UK real estate vs equities. But quoted REITs take on different risks. We consider few (RESI and, to a lesser extent, PRSR) are exposed to mainstream house price changes. The investment case is the income flow and its sustainability.

- There is financial gearing applied and both the interest rate environment and the availability of debt funding will affect the REIT.
- Financial gearing should be no higher than can be re-financed even were financial markets to turn sour. The shorter the facilities become, the greater the risk.
- Fixed-rate debt cuts both ways. Currently, rates are modest but one of the problems for certain REITs in 2009 onwards was the locking in (especially via derivatives) of interest rates which proved burdensome and indeed at worst constrained the ability to sell assets.
- For assets held on very long leases (i.e. c20 years) on good covenants, there is a temptation to view the underlying assets as of secondary importance to the 20-year income stream. Assessment must be made of the end-value once the lease ends. Discounting this to NPV starts as a modest element but mathematically it is of growing importance over time.
- The REITs can and do secure good net initial yields (i.e. at least the 5.3% All Property yield), but the robustness of the income varies. Each REIT has a distinct set of risks which we touch on, below.
- With initial yields seemingly attractive, there is a good element of cover against asset prices falling. However, it might be the case that the yield basis of UK real estate could rise, which would impact asset values. If investors seek income return over capital, this may be only a second-order problem. It is the income (and dividend) which is of primary interest.
- Sterling volatility has no direct impact but insomuch as it might affect inflation, REITs with a CPI/RPI inflator in the lease might be seen as having a modest hedge against falls in the £ sterling (recent and future).
- Investors must be careful and logical as to what returns they seek. With 20-year leases to HAs, some of the REITs covered will have income and capital returns only modestly correlated to the performance of residential (or any real estate) returns.
- Most of the REITs covered in this document (with Civitas Social, Empiric Student and GCP Student excepted) have not fully invested the proceeds of their IPO fund raises. Whilst they have outlined the strategy, execution is a risk. Civitas Social Housing has invested all its IPO proceeds and is raising further funds. Civitas would therefore appear to have a lower risk. However, it trades at a (very slightly) higher premium to NAV than others.
- On 13th July, Ian McCafferty, an external Monetary Policy Committee member, in an interview with *The Times* said the Bank might want to follow the example of the US Federal Reserve, which has outlined plans to begin winding down its $4.5 trillion stock of assets. The ECB has made its views clear.

The BIG one – what will happen to long-term interest rates when QE ends?

Bank of England Asset Purchase Facility

Current holdings £bn	£bn
Gilt-dged stock	435.0
Corporate bonds	10.0
Term funding scheme	89.4

Source: Bank of England

New investment drivers

Investors' scope for choice was small – not any more

Until 2013, Grainger Trust (not a REIT) or Unite (student housing) were the only 'quoted' ways to invest in residential assets. This scenario has all changed, with £1,282m raised since October 2016 in dedicated REITs. 1) Owners of the assets are recycling capital and, if only 1% of their assets change hands, that totals £3bn+. 2) Investors have seen good returns in student accommodation and the broader residential sector offers more (much bigger, with higher yields and more scope for yield compression). 3) Investors are disinvesting from open funds and into REITs.

In a world where 'what's next?' is a cry of confused dismay, here we analyse a recent development both creating social good and fulfilling an essential investor demand. There is a market opportunity to raise and efficiently invest a significant multiple of the £1,282m raised so far, for sustainable, moderate risk dividend yields of over 5% (this is on top of the distinct, specialist student REITs).

From zero to four residential REITs in one year

The asset class of residential REITS now comprises five REITs (including LXi with 36% of its assets in supported living and care homes). One year ago there were none; this excludes student REITs. These REITs cater to investors' search for attractive and stable yield. Former difficulties in sourcing assets have been overcome. Vendors package up into long leases and forward developments are undertaken. Difficulties centred around planning hurdles and low net rental yields on the largest investable asset class – private rental properties not purpose-built for private sector rental ('buy to let' yields under 3% post running costs). The two main sources of the REITs' assets consist of 1) social housing stock, looking to recycle capital; 2) newly constructed 'build to rent' stock. There will be other future niches too.

Social rental assets are being traded by owners motivated to recycle capital into development, hence they have evolved investor-friendly lease structures. The unlocking of social housing is an opportunity only recently being tapped.

One sector receiving investment is 'supported needs' social housing, with c.6% yields available

There is over £300bn of such social-rent stock. Three of the REITs invest in these assets. Further, 24% of LXi REIT's assets are in this sector. Housing Association owners can and do borrow, but are hitting ceilings. They are barred from raising equity. The alternative, namely recycling capital, was not actively pursued – but Housing Associations now seek recycling. Valuations on the portion of the stock which is 'Supported' (specialist requirement) are at gross yields of 5.5% or more (and on fully repairing commercial leases, so net is 5.5% or more). Until 2015, transactions were de minimis, being between Housing Associations. Bad debts are minimal.

The number of purpose-built private rental homes is woefully low. If we matched the US experience there would be a £800bn opportunity here

In the private sector, one attractive niche is 'build to rent'. Here c.10,000 flats are tenant-occupied, purpose built for rent. This is an astoundingly low figure. In the USA this asset class 'multifamily dwelling buildings' comprises c. 20% of the total estate, so the UK's current 15,000 would expand c.300-fold to match that – to £800bn. Tenants, developers and politicians seek growth investment. Aviva, M&G, SWIP and others seeking to match long term requirements have invested in schemes.

The new and still-small built to rent sector warrants attention – generating 20% gross margins for developers and securing 5%+ dividend yields on investment REITs.

20% gross margins to developers, 5% plus dividends to investors

Telford Homes and Watkin Jones, two well-established quoted developers, have opened new and (prospectively) dominant operations in 'built to rent'. Telford Homes' results indicate 10% lesser gross margins in BTR vs 'mainstream'. Yet the return on capital is equivalent. That is pure efficiency saving, passed on to the buyer.

Why the interest in residential REITs?

In summary – deployment of patient capital with 5%+ dividend returns

Forward funding

Residential REITs can access investment opportunities which look at long-term returns as opposed to the rapid profitable capital turn sought by developers. They are in an excellent position to forward fund developments, thereby boosting developers' capital turn. In addition, their tax status benefits this investment style. Another route for capital into new social housing stock is facilitating Housing Associations' sale and lease-back of assets. This can be problematic if tenants seek exits before the lease ends; this is not an issue in specialist social housing.

Sale and lease-back

Plenty of future avenues

Areas of future interest are legion – little investment is going into the large growth area of private sector built to rent. There is not, as yet, much stock here, but it is being developed and is an ideal source of long term income. Additional areas may include age-restricted assets. The supply of rental here is currently modest.

Why all these residential REITs?

Q: Why are all these residential REITs coming along now?

A: 1. Because, in the wake of the EU Referendum, many open-ended property funds (i.e. not REITs) suspended trading on the back of a wall of attempted redemptions. (we expand on each of the five, below).

......five big reasons

A: 2. Because the regular, rising and relatively high net initial yields on offer are attractive. The 'mainstream market' brings with it low yields (page 15) which is a real hurdle. The REITs have cleared this hurdle – but only recently and with major new types of occupancy structures (page 10).

A: 3. Because, until the past year, the assets were not 'packaged' in a way (e.g. long leases underpinned by excellent covenants) which warranted investor interest.

A: 4. Because the experience of specialist student accommodation has been positive.

A: 5. Because an expanding pipeline of assets has been secured. It suits the vendors to fund growth, both by disposals and forward funding, using 'patient' REIT capital.

Looking closer at each of the five topics in turn:

1. Open-ended property funds were 'sub-optimal' in the wake of the EU Referendum – REIT structures solve the problem

REITs are favoured partly because of open ended funds' problems. There is over £20bn in open-ended real estate funds (over £10bn in the largest names that we identify).

REITs solve the open-ended conundrum over liquidity

Even before the EU Referendum, Brandeaux student fund, on 31st May 2013, suspended trading. This was shortly after the City Regulator banned sales of unregulated funds, which tend to be illiquid but open to redemptions. It was just the largest of a series of student accommodation funds to suspend redemptions. Subsequent NAV write-downs totalled 11%, with management pointing to the "transaction costs incurred in providing liquidity and an estimated amount for the costs of winding up the fund". Hardman considers an 11% cost and a delay are reasonable, as property is illiquid.

But the illiquid nature of the real estate sector means REITs (CLOSED funds) are more suitable than funds OPEN to redemptions. Open-ended Liberty Living, Mansion Student, Braemar, Opal and others were hit. Open-ended structures (no matter how well-managed and the large majority are) are exposed to redemption risk. It not only

impacts liquidity but has a propensity to force purchases at the top and sales nearer the bottom of the market. REIT structures work: managers are free to manage, un-distracted.

Open funds total over £10bn, very likely over £20bn....

Hardman estimates the following pan-European open-ended fund managers (data in part from Real Assets IPE) were valued at, collectively, €10.4bn at September 2016, a date chosen as the period post the EU Referendum, when trading was opening up again. Aberdeen, Aviva, CBRE, Cromwell, Fidelity, Hines, Invesco RE, M&G, Standard Life, Tishman Speyer are included in this universe. In addition, large asset bases are managed by AXA, Barings, TH Real and others, but we have insufficient data on size. https://www.msci.com/documents/1296102/1672461/Excel2PDF_IPDOnlineAREFENHANCED+Q2+2015_Online.pdf/38856f83-4ec8-46fa-a9cf-6117a43f325e

.... and over time a good part will flow towards REITs

Assessing 1H17 investment trust cash flows, despite a total of £5.5bn inflows (IPOs and secondary issues) an estimated (Numis) £6.4bn of capital – before taking into account regular dividends – was returned to investors, up from £4bn for the whole of 2016. Nine funds were listed in 1H17, raising £1.45bn. In that half-year only £250m was raised in residential, as the large Civitas IPO was 4Q16 and several residential IPOs took place in July (see page 30). 2H17 will see a strong bias to residential REITs.

2. Regular, rising and relatively high net initial yields

Reason number two:

Investors (e.g. wealth managers) welcome long-term reliable cash flows, and also the transparency of the asset sub-class. The demand for additional affordable rental (allied to the large waiting lists) is acute and rising. This was the case laid out for student accommodation REITs four years ago (and Unite – UTG – since 1991) and investors have experienced attractive rent and also valuation improvements from yield 'tightening' (which is not required as part of the model on any REITs covered).

Student accommodation returns have been good.....

The net initial yield on 'all property' (IPD) is 5.3% (up slightly from the 4.9% cycle low reached in early 2016, see page 15), having peaked at 7.5% temporarily in 2009. For much of the period from calendar 2010 to 2012, the IPD UK all property index traded at between 6.2% and 6.5%. Prior to late 2016, the residential REITs were solely student accommodation. Property yields on student property have fallen to 5.8% at Empiric Student and to 5.0% at GCP Student. Unite's property net initial yield is 5.3%. Unite indicates (June 2017) 'London' property yields of 4.25%-5.0%; 'Prime Provincial' yields of 5.25%-5.75%; and 'Provincial' 6.0%-6.75% (which we believe is before certain property operating expenses, see the paragraph below).

With IPD All Property net initial yields of 5.3% and student yields at c.4.3% on a lease basis, the latter have to (and do) enthuse investors about tight supply and ongoing rent increases. We must emphasise that there are different types of lease on student accommodation. Leases direct to universities trade on net initial yields between 4.25% and 4.5% (prime regional – more in secondary regional, less in London). Source Savills http://www.savills.co.uk/research_articles/205506/202486-0. However, Savills also states that 'direct let', where the landlord takes the occupancy risk, yielded 5.75% (ranging from 4.75% London to 6.75% in secondary regional).

Turning to broader residential, net initial yields are as per overleaf. The 'targeted' segment is stronger than the word implies, as the figure is based on a secure pipeline.

......but residential now offers at least as high, if not higher, net initial yields

A word of explanation is required, as regards the student REITs; see [1] in table, overleaf. Student REITs' gross profits, as stated in accounts, are the figures used for the table below. We understand certain assets under development dilute the gross figure stated in the accounts. The column to the right is potentially a better comparator. As an example, GCP's weighted average property net initial yield

(September 2017 results presentation) is 5.03% (excluding Scape Wembley and Woburn Place assets that are not currently completed). Empiric's yield is 5.7%. Over and above the yield, both benefit from forward-funding returns. Our point is that the residential REITs' net initial yields (including *projected* yields) are slightly higher than those of student properties.

UK Residential REIT's net initial yields on assets as per value in balance sheet (i.e. not at cost)

REIT	LSE Ticker	Pre admin expenses: yield on gross assets % [1]	Asset net initial yield %	Date of float
GCP Student Living [1]	**DIGS**	3.8	5.0	May 13
Empiric Student [1]	**ESP**	4.3	5.7	June 14
Civitas Social Housing	**CSH**	6.0	6.0	Nov 16
The PRS REIT	**PRSR**	5.3	5.3	May 17
Residential Secure Income	**RESI**	3.5	3.5	July 17
Triple Point Social Housing	**SOHO**	6.0	6.0	Aug 17

NOTE [1] for Student REITs, see text ABOVE
Source: Hardman & Co estimates and Companies

We consider that slightly higher net initial yields are available in residential REITs than in student assets but we still see upside in student investment models (a combination of forward funding uplifts in a specialist sector and progressive rents).

3. Assets have been 'packaged' so as to warrant investor interest

Standing assets have been packaged and sold, then rented back for long (typically 20 year) leases, CPI inflated. This was not happening two years ago

HAs and Local Authorities seek a way of recycling assets as an alternative financing route, supporting their future development ambitions. This is the sale and lease-back (typically of 20 years) route. They take the occupancy and maintenance risk; this suits investors and tenants.

There is also a significant role for forward funding new development. HAs seek capital. From 1974 to 1988, they received government grants of up to 100% of the cost of development. The sector grew significantly. From 1988, government grant declined and debt rose. Grant erosion and increase in debt means some HAs approach gearing limits. They can and do borrow at fine terms but the movement's financial gearing has reached 48% and there is reducing headroom. The sector does not raise equity. Separately, care providers who own assets tend to be sellers.

4. Positive student accommodation experience is set to repeat

The largest student accommodation balance sheet is £2.34bn – in a sector much more niche even compared with the specific social housing sector

GCP's (DIGS) has achieved 14.2% pa total shareholder since 2013 float. We consider investors' positive student accommodation experience is set to repeat in residential REITs. The former saw yield compression and sustained tenant demand, which led to a strong rental background. The sector leader, Unite (UTG), became a REIT and has grown EPRA NAV per share to 669p (June 2017) from 417p (460p adjusted) ten years previously. The adjusted NAV fell to 265p at the end of 2009. It has £2.34bn of investment assets on its balance sheet (including the share of funds/ JVs).

Given Unite has reached £2.34bn of gross assets, there is logically scope for bigger vehicles in larger residential markets.

The student sector is (and remains) attractive to investors

The student sector is (and remains) attractive to investors as it comprises sizeable individual assets (i.e. blocks of student apartments/ 'halls') which can be built and managed efficiently and tailored to tenants' needs better than older stock. It also addresses a growing sector and one where typically a university will have three students per each purpose-built room, whilst much of the purpose-built stock is not up-to-date. Further, overseas students provide a good source of demand for a potentially differentiated product, with different price points.

In 2001 (Savills), All Student yields were 9.2% vs All Property at 6.5%. By 2009 a reversal: All Student 6.5% vs All Property 6.75%. We are intrigued by the Savills data, indicating minimal falls in student yields since then, whilst the All Property figure has reduced to 5.3%. Whatever the detail on the data (and that is an issue within a relatively small sector – still relatively thin data compared with some sectors), student yields have come in well, rents have risen and undersupply is still evident.

Student rent increases are running consistently over 2% per annum, often 3% up. We note some London students are proposing rent strikes, in part associated with maintenance problems. One of the issues, we consider, is where first-year students feel they have little choice – called 'nominated' first-year tenancy policies. For both Empiric and GCP, this nomination 'inertia selling' is not an issue – tenants actively choose these two providers. Student accommodation is set to continue successfully, but, with yield compression having occurred, location is increasingly important.

Now, residential assets in the new REITs compare favourably

1) *Significantly larger REIT balance sheets*
2) *Good yield compression over time*

Turning to residential, this is a much broader sector than just the one sub-sector like student purpose-built. It is a much more sizeable opportunity (vs the £2.34bn gross for example on the Unite balance sheet) and the pick-up in yield currently available is noteworthy (see page 10).

5. A pipeline of assets - £1.5bn equity a year needed from somewhere

Of the 23.5 million households in the UK, approximately 2.45 million are owned by HAs with a further 1.65 million owned by Local Authorities. The total value of this social housing stock is estimated to be approximately £300 bn based on the Existing Use Value for Social Housing (EUV-SH) valuation methodology. Hardman sees a potential 5%-10% of this stock being sold (long term) to third parties - 5% + of £300bn is £15bn. On top of this, is forward-funding demand from third party investors for new stock, very possibly a larger figure still.

A £15-30bn investment sector over ten years?

For new development, HAs are seeking, we consider, £1.5bn equity and £1.5bn debt from somewhere each year. A good proportion of the equity comes from re-investing rental assets. But equity via government housing grant peaked at £2.1bn in 2010 and fell to £300m in 2016. (Source Residential Secure Income REIT). This large gap has been plugged by debt, but that is now hitting a ceiling. The grant is set to rise (post the Conservative Conference announcement), but there remains a growing shortfall as the scope to raise debt has now reduced significantly compared with two years ago. Over the past ten years, the HAs have built and acquired, through planning guidance section 106, an average of 30,000 new units each year. The Conservative Conference announcement relates to funding c5,000 (only) per annum - hence the desire to seek investment partners to facilitate their provision of housing.

As a quantum indication, 30,000 new units a year, if funded 50% through debt and 50% from sales of other assets, would require c£1.5bn annually. The statutory rent-cut for 'mainstream' social housing has reduced HAs' borrowing capacity.

£1bn of disposals just from a single event

In addition, the 2015 announcement mandating social rent cut of 1% each year from 2016 to 2020 has caused merger activity. *Inside Housing* stated, for example, Clarion (the Affinity Sutton and Circle merger of Housing Associations) has announced that they anticipate that the merger should lead to the disposal of up to 10,000 units. Local Authorities traditionally fund housing developments through their Housing Revenue Account. The 1% rent cut figure affects them. To put it in some historical context, 40 years ago, this was the majority type of home but, since then, households in social rent have fallen to 4.1m (5.4m in 1980), way behind outright owners, mortgaged owners and private rental occupiers. In the past four years, this has started to reverse. We see much more to come.

What to look out for in these REITs

We provide the briefest of outlines on 20 significant issues for investors:

The size of the sector has grown rapidly and significantly

- Q: Why are all these REITs coming along now? A: Because they have found how to address the low yields and high property management costs of 'mainstream' residential assets.

Much of the market's yield is too low, but REITs have found the areas with high, sustainable income

- Q: What are the main hurdles to residential asset investment? A: First is the yield problem. 'Mainstream' residential assets yield 2.8%, net of substantial property management costs. See page 15. All REITs address this issue well (see table page 7). Net of all property cost, initial yields are over 5% with one exception - RESI's net initial property yield is c3.5%, with a REIT target total return of 8% per year.

- Q: What size hurdles present themselves? A: REITs need to be efficient and any with gross assets of below c£200m are struggling to be viable *medium-term* whatever the fee structure). If reasonable administrative costs are not covered well, there is a problem; this has only recently been overcome. All REITs have either achieved this level (including the pipeline) or have only a little way to go. Until the recent crop of REITs, the only bulky asset sub-class was student accommodation. There were no developers of private or public 'social' rented property looking for forward-funding and there were no large 'seed' portfolios around.

- Q: Will smaller REITs therefore feel under pressure to build a portfolio pipeline rapidly? A: Yes: assess carefully.

Many ways to select managers who can secure and sustain attractive yields

- Q: How do these pressures to invest get minimised? A: Managers might have a combination of expertise and early mover advantage (e.g. Civitas). They might have expertise in long-lease investments in regulated sectors (solar, municipal vehicles, lending). They might have direct track record as senior officials in HAs, backed by well-connected teams including expertise in tenant demand and management. Deep expertise in the forward-funding of commercial property assets let or pre-let on long leases across a wide range of sectors, or from housebuilders, can also maximise contacts to build a pipeline.

Two different types of REIT – some have (modest) scope to re-weight

  Importantly, investors need to differentiate between REITs dedicated 100% to a specific asset class and those where there might be scope to shift weightings between classes. Investors may proceed on the basis that it is up to shareholders to pick sectors as well as managers. Or some shareholders might prefer REITs where the Manager has scope to 'reposition'.

Motivated sellers of assets

- Q: Who is selling to the REITs? A: Forward-funding is a significant element, so there it is the developers who do so. They seek a high ROCE so the cash-rich REITs help in that regard, whilst their incentive is an attractive buying price. HAs are selling. Care operators are selling. And developers are building.

Good partners are in place

- Q: What is forward funding developers' risk-reward? A: In this case, no letting risk will be taken other than by The PRS REIT. If the relationship with the developer is in a sector niche, the developer will be an excellent part of the due diligence process in deciding whether the scheme proceeds. The REIT will have their own expertise plus the ability to pick and choose most attractive developers and schemes. Buying an SPV makes the stamp duty element of the cost attractive.

Regulatory and social context is supportive

Potential pit-falls seem well addressed

- Q: Are regulators, politicians and planners 'on-side'? A: Regulators may seek to encourage care home operators to divorce the property ownership. They will be happy to see BTR take market share from buy-to-let. Politicians are seeking ways to encouraging fresh long-term private capital into residential supply. Planners (in the broadest sense, including Local Authority Commissioners and those paying Housing Benefit) welcome developers who are backed by well-resourced long-term investors and, effectively, the most professional counterparts. For the most sustainable use of Housing Benefit, well- built, well-managed and maintained assets owned by stable investors will cause fewest problems.

- Q: Maintenance and running costs are major considerations in residential. How is this issue dealt with? A: Social housing REITs outsource all these issues under lease or rental agreements. PRS REIT buys modern stock in readily managed condition. Some risk remains.

There are details to explore regarding valuations at the end of the lease

- Q: Does property yield constrain gearing on interest cover grounds? A: No (albeit few, if any, will target gearing of over 40% Loan-to-Value with Civitas at 25%). This is addressed by the REITs successfully achieving net initial yields of over 5.3% (ReSI acquires properties at lower yields than the other REITs, but uses low coupon inflation-linked debt to maintain high interest cover). Gearing can be at 50% levels, provided the assets support investment grade debt, which is particularly relevant to higher quality assets, which may have a trade-off of a lower net initial yield. The All (commercial) property net initial yield is 5.3%. Page 10 lists the target blended net initial yields, namely 5.3% – 6.0% (bar ReSI).

Forward funding partners must illustrate mutual benefit in more than just the 'deal-driven' financials

- Q: Is this a sale-and-leaseback deal for the vendors which could lead to regrets? A: Yes and no. First and most significantly, 'no'. Sale-and-leaseback is inappropriate for occupiers who may wish to vacate and subsequently might struggle to find a new tenant. Local Authorities and HAs that are selling have selected assets in areas of long-term tenant demand (we would hope) and, given the residential shortages, this should not be too difficult. Assets are currently valued on a basis of a market which had, up until 2016, seen very low net money being invested from outside the existing sector. Valuations have come from players swapping assets or from lenders' due diligence. We believe that the assets are not being traded at prices that either side will subsequently regret. The vendors keep the risk of tenants paying their rent. The sector has high arrears, low default. They assets *are* being sold for a social need, however – to develop more, new, units.

- Q: Is there a significant lack of visibility for a 5 or 10+ year commercial contract? A: No. This is either packaged as a 20-year contract, or is in areas of high demand.

- Q: Is there a value destruction in tenanted vs empty assets when it comes to sale? A: if a discount pertains (at times it is a discount, at other times a premium for a tenancy) the assets are bought tenanted i.e. there is no value erosion. However, PRS REIT does buy new and then finds tenants, with families seeking three year+ tenancies. See the following point.

- Q: Some REITs target specialist assets (Civitas has 75%+ in houses converted to suit tenants with special requirements, Triple Point has significant exposure to such assets whilst others also have a mix). Is there a risk of obsolescence? A: Yes, hence the extensive due diligence) that creates a price premium for the few which pass through the DD 'hurdle'. Note that the length of the lease thus is a major criterion in this situation. Note also that the occupants welcome the opportunity to secure effectively lifetime security.

- Q: Are these REITs buying new and what risks does that pose? A: Buy to let seldom does well buying new as the 'balance of pricing power' lies with the developer for 80%+ of the time. So, the REITs who do buy new must ensure they have the buying power vs the developer. There needs to be (and this market offers plenty of opportunities) mutual benefit. Forward funding is a successful tried and tested method for both residential and commercial property. This is not all about the balance of pricing power. It is about mutual expertise in a series of niche markets, helping each partner grow sustainably. We like situations where the developer has deep knowledge regarding the occupier of the asset being developed – including the Commissioner at the Local Authority.

- Q: Is there a significant tenant-default risk, or at the least a high cost of collection? A: No. The social housing REITs are in a sector where default rates are <1% - surprising as that may seem to some investors. For the others, it is too early to tell. However, even buy-to-let sees defaults but the write-offs are under 2%. However, (source Mobysoft), of the UK's 1,650 social housing landlords, the largest 100 faced more than £700m of gross rent arrears in 2016. Tenants receive Housing Benefit (where appropriate) at a set Local Housing Allowance (LHA) rate (typically <£400 per month in the Midlands and in the North for a one-bed flat). Landlords can and do charge more than this; hence, there is some potential risk on the tenants' finances. LHA rates are materially different for tenants with specialist requirements.

Whether it is in the NAV or not, as the holding size grows, a portfolio premium accrues in attractive and difficult-to-buy-in size, SPECIALIST assets

- Q: Is there a portfolio premium? A: Jones Lang Lasalle has ascribed a premium to the Civitas portfolio and there has to be a debate as to the whole sector. One upside is the (as we see it) likelihood that overseas investors will become interested, in due course. Valuers' views are less important than weight-of-money. As the sector gets bigger in size (AUM), it will attract growing interest. Really, the share price rather than NAV, should be the arbiter.

- Q: Could rents go down? A: 1) Yes for PRS. 2) The non-purpose-built specialist social assets are held on long (e.g. 20+ year) leases, but there is a risk at the end of the period, which Civitas and others have to manage (again, investors need to consider the due diligence discernment of the REIT).

- Q: Are there political risks? A: Many – see pages 16,17. They change over time.

- Q: Valuation: were long-term rates to rise, how would the sector be valued? A: Net initial yields mostly range from 5.3% to 6.0% (maybe more on forward-fundings). This compares with the current IPD All Property 5.3% yield. This premium helps. The main risk would be if market (i.e. swap) rates rise as a result of economic strength. This might translate into higher rents for All Property and maybe PRS REIT (when tenants vacate) – but not for social accommodation assets' whose long-term leases tend to inflate through CPI inflation. For CSH, SOHO and RESI, this may not lead to NAV falls but may cause asset and rental underperformance v the broader property market.

Question 2 in the list above – net running yields – merits more analysis

Next, we turn to the problem which has been solved: the low yield of 'mainstream' residential assets, net of running costs. Investors seek long-term, secure income streams and attractive, progressive dividend yields. The REITs, we consider, all provide a successful answer.

The yield problem solved

Without decent asset yield, a REIT structure would not work.

The 2.8% yield shown is this table is unattractive....

REITs have tapped a large new market for residential assets which circumvents this negative issue. Looking at the mainstream market – the type which buy-to-let investors target – a (very large) 'fly in the ointment' is the figure for residential income return (see below). This is the net yield (after significant maintenance costs) derived from rent. Residential net yield is 2.8% (table below). This is less than 60% of the yield on 'all property'. Note also that VAT is chargeable on maintenance costs and many small investors will not be registered for VAT.

Annualised total returns

Asset class	Index: 1980 = 100	2016 INCOME return	1 year	3 Year	5 year	10 year
Residential	8,320	2.8	2.8	8.3	11.0	9.6
All property	2,140	4.9	13.1	13.8	10.5	5.7

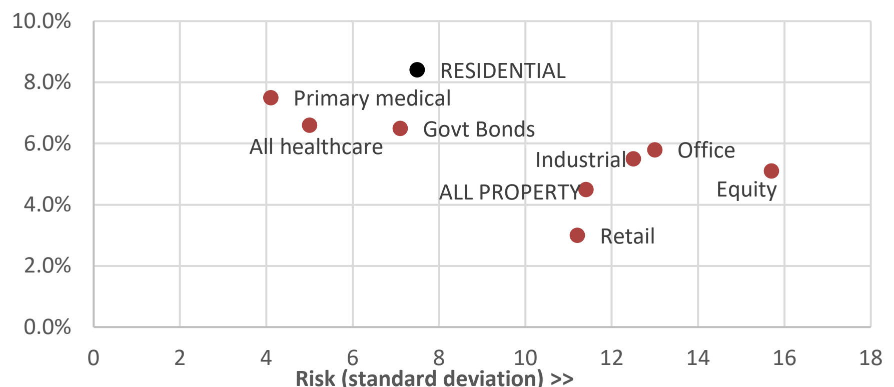
Source: IPD/ Hargreaves Lansdown

By comparison, the Equities index comparable is 4,200 with an income return of 3.4%.

Total-market residential asset performance has been good. Residential assets appear to offer (over the past 10 years, i.e. since the previous peak) pre-tax total returns of 8.4%. They also have delivered this on a standard deviation well below (i.e. lower risk) than all property, equities and on a virtually indistinguishable risk vs government bonds.

.....but the investment is into assets with a good track record of returns and low volatility

UK residential returns



IPD states 10-year Sharpe ratio of 0.9, and standard deviation of 7.6

Source: IPD/ MSCI

The risk to the 8.4% CAGR number (over the past ten years) is that the income return (pre-tax, net of property costs) is 2.8% (IPD) v 4.8% for all property. The risk captured in the chart above is simply the volatility of the total return (quite low). But more importantly, the greater uncertainty is whether the 2.8% net initial yield is anywhere near enough to sustain total returns in the future and secondly to support the current valuation.

The social housing REITs have side-stepped this dilemma as the forward-funding and the sale-and-leaseback of social housing is based on commercial style leases where running costs are no longer a factor - when buying individual houses or flats, they very much are. Separately, the PRS REITs (and, we assume the K&C REIT's) answer is to forward-fund developments that are designed to achieve rents and maintenance costs which result in investment returns above the desired hurdles.

Politics

The Budget

Housing matters more, politically, than it did before the 2017 election: the vicious circle of "they [millennials] don't vote so why focus on them" has been broken. The Budget was announced on 22nd November. We consider the £44bn guarantee 'headline' number is unlikely to change much. Taxing capital gain on overseas owners of UK commercial property may encourage a move to REITs (from direct-owned).

Nimbyism seems less acceptable

Permitted development

Calling out 'Nimby' as being negative has often been avoided by Conservatives, but Sajid Javid MP, Secretary of State for Communities and Local Government, emphasised in his Conference Speech) the Government's broad desire for more housing supply. The Spring 2017 Housing White Paper proposed standardising local housing need assessments whilst a Housing Delivery Test will make it more difficult – especially in the south – to refuse strategic planning. There was also a 'mood music' positive about (non-specifically) encouraging building upwards (to the height of neighbouring buildings). Projections (Apex Housing) highlights the scope in London alone for £54bn of gross development value (GDV) potential on residential rooftops. This is piecemeal and is unlikely to be the kind of stock going to REITs.

Help-to-buy concerns – Stamp tax exemptions may help first timers but unlikely to expand supply

The Conservatives' extension of Help to Buy had faced criticism and indeed there is anecdotal evidence that new London developments priced under £0.6m per dwelling sell well, but at over £600,000, there is a significant problem. There are concerns the policy is inflating new-build prices. The additional £2bn phased over some five years is a welcome 'foot in the door' to central government-funded 'council housing' and, as such, the token is very useful. In effective volume terms, it is not. Releasing the capital receipts from prospective Right-to-Buy of local authority owned properties, for the purposes of new building, would have been welcomed – it was not to be.

Social rent cap impacts on owners' balance sheets

Social housing rents are capped to CPI minus 1% pa. After 2019/20, CPI +1% ie back to the previous cap limits. This reduces the asset values of social housing (as the NPV, mathematically, reduces as a result of the temporary, but material, rent cap). This knocks on to reducing the ability of H As to borrow and has a real, negative, impact on supply. Four HAs are in the top 20 UK housing developers. This will probably not fall, but output might. The impact of the Grenfell Tower tragedy highlights a major and urgent investment requirement diverting funds from new-build. Specialist needs are not subject to the cap, an important permanent distinction.

A precedent

Why, if the Government mandates rent cuts in social housing, could the private sector not be affected? Or greater social rent cuts? Why indeed – however the argument might be that the Government pays much of the rent in social housing so should have a legitimate voice about its operation. Here, CSH and SOHO are not exposed, but the lessee is.

Shared ownership boost: ReSI REIT focus

Reduced UK government grant is causing HAs to seek third party equity capital from debt and from recycling assets. They are not allowed to raise equity. Government housing grant expenditure peaked at £2.1bn in 2010 and fell to £300m in 2016. It averaged £500m in 2012-2016 (v £1.3bn in 2006-10). HA gearing has moved from 40% in 2006 to 48% in 2016 (source: HCA). By contrast, the Government has currently ring-fenced £4.1bn to support the delivery of 135,000 shared ownership units. Delivery of shared ownership clearly is moving higher up the political agenda. This is a focus for RESI.

Lib Dems

The Lib Dems' leader stated "I want to see fierce tax penalties on the acquisition of property for investment purposes, by overseas residents. I want to see rural

communities protected from the blight of absentee second home ownership." This would be a positive for professionally owned and managed residential assets, either through reducing land costs and thus raising rental yields or boosting BTR.

Can Labour be amicable to investors?

The Labour Party's 2015 manifesto promised a three-year tenancy, index-linked, with reversion to market at the end of the three years: the policy did not change for 2017. This would be nirvana for high-quality residential asset owners / managers. Many tenancies are longer. In 2015, Allsop's fifth annual "Rent Check Report" findings showed the average tenancy was 2.7 years in duration, up from 2.5 the year before (mathematically, the average length at tenancy end would be longer). Landlords and tenants both welcome lengthened tenancies. Jeremy Corbyn's 2017 Conference speech appeared to focus on local controls. There are two precedents. The Scottish model of tenure reform, with a trial of open-ended tenure, goes live in December. This would be good for professional owner/ managers but a huge potential problem for 'amateur/ accidental' landlords who might want to sell the property vacant at some stage. As for rent controls, see the paragraph below on 'rent pressure zones'. Local government will control. Turbulence might ensue. They could have very different impacts across the country. Conservative councils might find this ideologically difficult, although Labour would potentially not (perhaps particularly in areas with a City Mayor). The second precedent is local zone planning policy. Article 4 directions are designations that a Local Authority can introduce to remove permitted development rights. This was brought in 2011, under a Conservative government, devolving powers to Local Authorities.

Labour: LOCALISM

See Scotland

Edinburgh – a possible template for 'rent pressure zone' controls

Both Conservative and Labour have embraced a policy of localism, restricting planning permission (indeed that started in the 1947 planning legislation). Labour has endorsed an applied policy (as of this December) of open-end-dated tenancies. It may go beyond its stated policy of rents rising from current levels at RPI (which would appear to be something landlords would welcome). An interesting potential portent is Edinburgh, debating the subject of applying rent caps. http://www.edinburghnews.scotsman.com/our-region/edinburgh/edinburgh-set-for-new-us-style-rent-control-powers-1-4412109 Currently, the proposal is not to reduce rents: the clear 'pressure zone' area is to be set. This is similar to Article 4.

Article 4 under a Conservative administration – all this appears not to affect any of the REITs covered

An article 4 direction is made specifically by the local authority. It restricts the scope of permitted development either in relation to a particular part of town, or particular type of development (e.g. student). Where article 4 is in effect, planning control is tighter. There are many examples of such local restrictions nationally. For example, an Article 4 Direction came into force in Oxford in February 2012, introducing local planning controls for HMOs in the whole Oxford City Council. A city-wide Article 4 relating to HMOs was adopted in Southampton in March 2012.

Supply – any ideas please?

This leaves the big issue: supply. Under-supply may well be supporting residential values and rents too may be inflated as a result. Investors must form their own view. As at April 2016, there were 1.1 million households on local authority housing waiting lists seeking low cost rental accommodation. From a peak of 1,400,000 mortgage approvals in 2006, only 799,000 mortgages were approved in 2016. We have pointed to supply from HAs. As an example, L&Q (one of the largest RPs) plans to develop 25,000 BTR private rental properties in the next ten years. Many private housebuilders' models are based on ROE, not on turnover. Land availability is not the constraint: much of the land is in the public sector. As an aside, this is the model espoused by Kier for example.

More moving as well as more houses – elderly have a role

Downsizing by the elderly would be facilitated (Demos report) by a new local council development tax methodology excluding common parts. Further, incentives to downsizing (e.g. Stamp Duty) would add to habitable space for younger people.

Attractions for investors: summary

Summary of investor appetite

Moving investor funds to the more appropriate structure: REITs

- **Liquidity:** the 'closed' structure of REITs is better suited to long-term investments (many leases run for 20+ years) than the open structure of the well over £10bn of open-ended property funds in existence. We suspect money will move - is moving - from one to the other.

Residential offers: Income (PCBs cornerstoning the market for this)

- **Income:** the search for quality income remains high on the list for investors. Residential, more recently, has been packaged in the ways we describe above, in institutional-style leases and with a much higher ratio of net to gross income than seen, for example, by buy-to-let. The REITs' Prospectus targets are 5% to 6% progressive dividend yields at flotation (PRS REIT being the 6%).

Lower volatility

- **Capital appreciation:** we anticipate this being more in line with the RPI rise in rents rather than with the broader UK residential house price indices (see more detail in the REIT specific analysis). In any case, IPD data (see page 15) show a residential assets' ten-year standard deviation of 7.5% versus 11.5% for 'All Property'. It exhibits a lower standard deviation of returns over time.

A 'follow-on' from good investor outcomes in student accommodation

- **It's been done before:** The success of purpose-built student property moving into the mainstream and 'tightening' yields, have shown the way. Of course, the experience in open-ended student funds was not so good (see bullet point one).

Huge size potential

- **BTR could be huge:** c20% of US housing stock is BTR. US investors are looking at the UK. The UK figure is under 0.1%, but is growing at some 20% per year. We believe the growth will accelerate well beyond 20% per year. Why would institutions buy BTR? 1) Developers make 10% lower gross margins: buyers deal on cheaper pricing. 2) Efficient running costs.

Major hurdles have been successfully addressed as follows:

Problematic issues, such as inefficiencies in running and development costs have been overcome in the investable *parts* of the £6 trillion housing market.

Build to rent provides efficient solutions (to occupiers and investors)

New BTR blocks in which to invest (or forward-funded estates of open-market rent properties) provide large, investable assets with economies of running costs due to scale and modernity (reducing the gross-to-net rent reduction). Development for BTR appears scalable (volume demands and rent affordability) and more so than student purpose-built accommodation; furthermore, it is much less cyclical than build-for-sale. As Telford Homes demonstrates, a much lower gross margin (14% for BTR vs 24% for individual sales) still translates into equal or higher ROCE (see page 44). This can be seen as a pure efficiency saving of the 10% lowering of sales price, indicated by the gross margin discount. There are also Stamp duty advantage. Even so, it is early days and the yields may still not be quite enough (in good locations).

Specialist expertise has found ways to be rewarded by adding real value

Specialist sub-sectors can prove attractive. For example, Civitas (CSH) directs well over 75% of assets into social housing for specialist need tenants – Triple Point (SOHO) too. This needs deep expertise, including within Local Authorities, and excellent developer partners.

There are other sectors which reward deep specialism, such as elderly. A recent paper from Demos indicates the major social advantage from a rise in the modest supply of purpose-built retirement housing.

The attraction, now, stems from three simple points:

- The market is so large (£6 trillion) that only very specific sub-sectors need to be found which satisfy requirements for long-term sustainable returns.

Forward- funding – yield arbitrage, just one of many opportunities

- Forward-funding in social housing is just one example of a specialist area. Specialism/newness of the sub-market tends to be rewarded with a higher uplift between the forward funding 'in' price and the ultimate valuation.

- Hence, REITs structures support sustainable dividend yields of 5% plus.

In addressing this market, we analyse Civitas Social Housing (CSH), The PRS REIT (PRSR), Residential Secure Income REIT (RESI), Triple Point Social Housing (SOHO) and also the developers, Telford Homes (TEF) and Watkin Jones (WJG). LXi REIT (LXI) has a slightly different strategy with 46% of its assets currently being represented by supported living and care homes, as per LXi's reported results on 23rd November.

A positive contrast to many REITs

Cash = profits in the new residential REITs…no 'rent frees', derivatives.

Cash = profits in these residential REITs. For the REIT sector doyens, British Land (BLND), Hammerson (HMSO), Intu (INTU) and SEGRO (SGRO), the same is not the case. For example, lease incentives (rent-free starts) are a complicating factor but not for the residential REITs. Commentators make a broader point of the exposure of these stocks to an economic downturn. Most residential REITs are properly seen as INFRASTRUCTURE plays and should have minimal income or covenant exposure to downturns. PRSR's exposure (through Assured Shorthold Tenancies) being reasonably limited (and we note the lower historic volatility of residential assets v commercial). Further, since 2012, analysis (Radnor Capital) shows UK REITs are now owned 25% by 'property-dedicated' active funds, down from 33% in 2012.

Major investors are seeking new real estate asset classes

LXi REIT (LXI)
104p share price
105p NAV
£205m market capitalisation

LXi REIT (albeit only 46% of its NAV) holds supported living and care homes. It has secured two debt facilities including 12-year debt from Scottish Widows (at 2.9%) from its annuity lending pool (cf Civitas). This segment of the lender is dedicated to its lowest risk pension assets, we believe. On page 31 we provide a brief summary of our view on LXi. It has fully deployed its second, £60m, equity raise. NAV is 105.1p.

Furthermore, institutions have an appetite for 'emerging alternatives' such as student, storage, supported living, hotels etc. We cite as evidence that, as recently as May 2017, AEW (a €60bn manager) announced its intention to raise £150m via an IPO of the AEW UK Long Lease REIT (AEWL), specifically focused on "a diverse range of sectors that are under-represented in institutional portfolios". Residential, an 'emerging alternative', will become mainstream but it is not yet – in the UK.

AEW UK Long Lease REIT (AEWL)
102p share price
£82m market capitalisation

On 6th June, AEWL did raise £80m in its IPO, although it announced on 11th May 2017 that it was seeking up to £150m. AEW's fund happens not to list residential as a new asset class "under-represented in institutional portfolios." This is via leases, on acquisition, averaging longer than 18 years. AEW forms part of AEW Global, with more than €60 billion of assets under management.

To date, purchases average 5.7% net initial yield. AEW's selection screen includes assets where yield compression boosts values – overlooked niche sectors. Having met with AEWL, it is clear that assets benefit both from being on long leases with robust covenants and also from strong underlying value intrinsic in the asset itself.

How it works

Why investment in social housing is rising fast

See page 26

With 'open market' housing being expensive and many housebuilders' models being quite legitimately focused on 'bottom line' financials more than the 'top line', there is a major role for fresh capital in developing social housing.

Socially useful and effectively funded – HMG encourages it

The Government's Homes and Communities Agency's remit includes promoting new stock through leveraging 'private' money to be invested in the sector. Institutional investment accelerates housing delivery for social housing providers, many of whom are ambitious to grow but have already expanded their debt ratios. Yet, since the late 1980s, the Government's grant has declined and HAs have taken on more debt to facilitate development.

Housing Officers assess individuals' needs and set rents

But the increase in debt means individual HAs are approaching gearing limits. Other factors also impact HAs. First, the rents charged for new social housing have tended to be raised above historic levels. A definition of 'affordable' now includes rents as high as 80% of open-market levels. This facilitated development but it was also accompanied by rising debt. Since 2016, a new regime of mandated rent reductions on 'general' social housing (of 1% pa for four years) has been put in place. This in itself puts pressure on HAs to seek efficiencies, to borrow more (on slightly less attractive security) or to seek external funds – or a combination of all three. The many Housing Officers within Local Authorities assess individuals' needs, refer them to welfare services and also set rents in conjunction with landlords.

Government-backed income

Investors see an income stream which typically is 75%-85% from the Government (tenants pay some rent themselves) and management costs can be packaged on institutional-scale developments. Yields are attractive at both gross and net levels.

Why investment into BTR is rising fast

Buy-to-let is likely to remain a major force, but it faces significant and increasing headwinds – which will not reduce

98% of open-market rental property is inefficient: owned by buy-to-let (or a reducing quantum of tied or employer-owned dwellings or charities). Both regarding tax and operational costs, the sector is inefficient. Buy-to-let, as of a year ago, had a 3% Stamp Duty surcharge imposed on all purchases. Tax deductibility of mortgage finance is now being reduced then withdrawn (though some properties are bought for cash). Further, lending criteria are being tightened (though some commentators over-play this last point). The quantum of buy-to-let purchases is falling. More to the point, we have outlined how running costs are higher than BTR.

BTR's lower selling costs and quicker capital turn save significant costs. A better-value product can tip the balance into MUCH higher volume demand. Evidence from the US and from many other overseas markets points to very large latent demand.

Build-to-rent: 20% of the US market vs 0.1% of UK stock

Buyers of purpose-built stock (build-to-rent, BTR) benefit from savings that developers receive: this should catapult volumes.

Knight Frank estimates that £25bn has been invested in the sector (land, work- in-progress and completed assets) to date and forecasts £70bn by 2022, half of which is from the US and Canada (Property Week, May 2017). This includes land and work in progress. US and Canadian investors are anticipated to continue to be significant elements and the US developers are also taking a front seat. Greystar, one of the biggest US operators, is building 2,000 homes currently, for example. The Canadian developer and pension fund subsidiary, Oxford Properties, is mentioned (Property Week, May 2017) as planning significant investment. (oxfordproperties.com).

Private rented residential assets

Of 4.4m private rented dwellings - only c15,000 are purpose built…

- Quicker build brings efficiencies to all parties: investors, developers and land owners, especially for strategic, regeneration sites.
- Much is being done by HAs (L&Q, Places for People and many others) but there is only so much they can do without partnering-in fresh capital.
- North American and other global examples point to how far behind the UK is – for flats but also for family houses and specialist areas such as the elderly.

Currently, c98% of this asset class comprises non-purpose built rental dwellings. There are c4.4m dwellings rented privately in the UK. On top of these, some 50,000 beds are in purpose-built student accommodation. There are c15,000 purpose-built rental apartments (build to rent or BTR) excluding these specialist student blocks. If the recent trends of rises in rental continue, c1% per year of the UK owner-occupied stock would migrate to rental. This is approximately 0.25m dwellings per annum. In addition, the growth in the total stock and the regional migrations would enhance this 'latent' demand. See our summary on the previous page.

… a clear market demand, to date undersupplied to a dramatic degree

Currently, a fledgling sector in the UK, the US market has grown from £1bn to £80bn since 1992. Similar growth in the UK could easily see 250,000 units delivered by 2030.

Build to Rent (BTR): a large potential asset class

Latent demand could comfortably be 250,000 dwellings per year. We consider recent graduates and families to be two prime categories of demand. The former tend to move less frequently and the latter may regard their dwelling as a long-term home for the family.

Build to rent by Fizzyliving (subsidiary of Thames Valley HA)

Location: Poplar, London

Source: Fizzyliving

Governmental encouragement nationally…

…..and locally

The Government has instigated a £1bn Build to Rent Fund. This is a small sum, but indicates a 'positive direction of travel' towards the sector. Given the importance of the 'localism' agenda, speed of housing delivery makes BTR attractive to Local Authorities searching for ways to meet their housing need locally. The Housing White Paper includes proposals to change national planning policy so that Local Authorities must proactively plan for BTR. The Housing White Paper was no more than consultative and none of the investment case depends on these political

contingencies, positive as they are. Unlike the new build 'for-sale' market, BTR developers can proceed more rapidly, unconstrained by varying sales rates. Investors look to initiate their income stream as soon as possible. They are not focused at all on maximising unit values, rather on maximising the value, long-term, of their income stream. New owners and operators in BTR include Fizzy Living, Get Living London, Essential Living, Fabrica and Diffrent. Investors seek to avoid taking planning risk but understand they have to engage with development risk and with managing occupation.

Housing Associations are substantial developers and investors

Many active operators are Housing Associations: L&Q; Places for People; Notting Hill; A2Dominion (T/A Fabrica); and Thames Valley (T/A Fizzyliving). Places for People launched an investment fund to own and manage PRS for third-party investors.

Private operators (many from North America) include Greystar; Get Living London; Westrock; Essential Living; Grainger; and Moda Living.

Investment managers in the sector include M&G; Aberdeen; L&G; Lothbury; Invesco; La Salle; Hermes; APG; and Rockspring.

The completed stock list shows how small the sector is

UK's completed purpose-built rental units

Owner	Note	Units, completed
Get Living	[1]	1,813
Sigma Capital	[2]	1,590
L&Q Housing Association	[3]	1,482
LaSalle	[4]	1,059
Criterion Capital	[5]	880
M&G Real Estate	[6]	870
Invesco	[6]	699
Fizzy Living	[7]	647
Aberdeen Asset Mgt	[6]	545
Bravo Management UK (Bravo Investment House)	[8]	481

Source: Savills, Glenigan, Molior, BPF, Sigma Capital

Several owners and recently formed corporates focus on this area

[1] Launched 2013 – 3,400 occupiers, principally former Olympics site – Qatari-Delancey JV.

[2] Founded 2001, has developed c.3,500 new homes and schools and leisure facilities making new communities. Developer and Asset Manager for PRS REIT, so rapid substantial growth is in store (see table below).

[3] Last year, homes in the L&Q development pipeline rose from 13,500 to just short of 40,000 homes. This included social, shared ownership but also BTR (see table below).

[4] Global real estate (assets, funds, debt) investor for clients (NB: JLL, the valuer, is a sister company).

[5] Criterion Capital is a UK-focused real estate asset manager that identifies, acquires, develops and manages real estate (principally commercial) on behalf of long-term Investors.

[6] Life and other funds' investment.

[7] Founded 2012 – London portfolio of five BTR schemes (with 800 in its pipeline).

Many, including L&Q, Greystar, Sigma and others have scope to much more than double the pipeline

There are some private vehicles, but for REITs, The PRS REIT (by Sigma managers) is unique

[8] 20 years' experience of offering investment advice, sourcing, financing and managing over 1 million sq ft of residential, commercial and hospitality assets. Short and long-stay residential. It invests alongside third-party investors.

Below, we list a league table of the largest owners of pipeline assets in new BTR stock. All stock, except some of Grainger, some of Dandara and all of Sigma, are aprtments.

Quintain is a developer of large strategic sites, principally in London. Apache Capital and Moda Living are working together. The latter has a pipeline of 5,000 'currently deliverable' as per the Moda website, so our table below may understate its assets; this portfolio is across the UK. The joint portfolio targets a £1bn asset delivery. Apache Capital Partners is a London-based sector investor, including care and PRS.

Greystar is a very large North American investor with significant investment 'firepower'.

Argent is a UK property developer specialising in mixed-use development with a focus on placemaking and regeneration. Dandara is a mixed-use developer with onshore – and some offshore – exposure.

Grainger is a large UK-quoted residential real estate owner with over 100 years of experience it is diversifying away from regulated rent sectors. Grainger develops apartments and houses for rent (c400 of the latter). Its new management has refined its focus.

UK's development pipeline of purpose built rental units

Owner	Units, completed
Quintain	4,497
Get Living	4,232
Apache Capital and Moda Living	3,200
L&Q	3,156
Greystar	2,751
Argent related	2,720
Dandara Group	2,411
Grainger	2,386
Sigma Capital	1,758
Criterion Capital	1,685
Notting Hill Housing	1,409

Source: Savills, Glenigan, Molior, BPF, Sigma Capital

The pipeline remains modest but is rising rapidly. Many in the list above would have a potential pipeline of twice the size of the short-term deliverable stock listed above, particularly from the third entrant and below.

The UK Government is encouraging BTR. One example is the Home & Communities Agency's £25m investment in PRS REIT (Sigma Capital managers); a stake just under 10%, the maximum individual stake allowed by REIT legislation. Another piece of evidence is the summer 2017 Housing White Paper which is long on encouragement but short on funding and fact; it does highlight strategies which are here to stay.

Sigma has developed BTR for Gatehouse Bank. Founded in 2008, the Bank operates in real estate investment and lending, in accordance with Sharia principles; its investment team is responsible for US$1.2 billion in real estate assets.

How to invest and why so few UK vehicles to date?

Just one REIT so far

Currently the PRS REIT is unique but, given the large number of such assets in the US, there will be more built in the UK, we believe. Why are there so few to date?

Yields are low in the non-purpose-built sector and the BTR stock is tiny. Knight Frank states (gross) rental yields for a range of modern assets. Yields rise to 5.0% - 5.5% GROSS for secondary regional cities. We have highlighted that BTR running costs are more efficient. A 5.5% gross yield on its own would not support the level of dividends that investors seek. Net yields in non-purpose built residential rental assets can be a lowly 50%-60% of gross yields. It is noteworthy that the one fund to be raised focuses on a region (north of England and Birmingham) which offers yields above the UK average.

The PRS REIT raised initial equity of £250m in May 2017. There is one further REIT but the NAV is only £4.3m. K&C REIT plc saw admission to AIM in July 2015, acquiring assets in the private rented sector. K&C is looking to broaden its activities to include retirement residential, namely assisted living and care. A follow-on fund raise has been announced but the timetable has stretched.

Strategic regeneration, 'getting large sites started'

We do not see BTR as relying on additional planning 'breaks' but it is a mode of regeneration and of rapid supply-side impact. Therefore, in some way, this should be reflected in lower BTR land costs for large sites, to 'get a site started.' Certainly, this is part of The PRS REIT's attraction.

Provision for elderly is very low

We consider there will be significant growth through a number of different vehicles, including quoted and unquoted funds. Specialisms may prove attractive. We see the elderly market as one which is particularly under-served currently.

Occupiers

The first REIT's focus is creating stock for families

Flats may tend to be occupied by young professionals, post university, typically on decent incomes. Houses may provide for families seeking accommodation which contributes to their well-being, stability (longer tenancies), and which is affordable.

It might be too far to argue that renters would be looking at the specific development and not comparing the offering with the local housing market at all. But this would be more likely the case in rental than in build-to-sell.

What drives BTR investor demand?

All this is underpinned by the very nature of 'purpose-build'. It creates 'efficient' and attractive assets

Cost efficiencies are a major benefit. BTR is attractive as lifetime costs are much more readily modelled than non-purpose built. This is a key help to investors but also to occupiers. Well over half the lifetime cost of most real estate (commercial or residential) is the running cost as opposed to the initial capital cost. We therefore look at 'Build to Rent' (BTR) in part because of its 'whole life' benefit, both in user experience and in cost. Purpose-built modern stock in larger blocks offers occupiers much better direct communication with day-to-day managers and is much easier to undertake planned cyclical maintenance. This brings efficiencies. So too does the low land cost.

c.20% of the whole US market is BTR vs effectively nil in UK

Some background

The majority of money investing into BTR is currently North American and UK investment funds seeking to match their long-term assets and liabilities. For this reason, long-term interest rates will be a significant consideration. North American investors are familiar with BTR – or 'Multifamily' – as an established asset class.

The student market has been a success but surely BTR should be larger

At present, the build-to-rent market is substantially smaller than student purpose-built but is set to become much larger. Currently, Unite Students is the UK's largest manager and developer of purpose-built student accommodation. Were BTR to achieve US style penetration levels, the stock would eventually comprise almost 5 million apartments. The quoted developers we look at, Telford Homes and Watkin Jones, offer substantial scope for expansion. See p. 48. Estimates vary, but the total stock of open-market rent apartments in the UK which were built specifically to rent numbers c15,000 (under 0.1% of the total residential stock), with 9,000 in London.

http://www.bpf.org.uk/sites/default/files/resources/BPF-Build-to-Rent-Welcome-to-the-UKs-newest-housing-sector.pdf

Strategic, stated targets

The Mayor of London has a target of building 42,000 homes in London every year (recent delivery has been sub 30,000 pa), with 5,000 of these coming from the Build to Rent sector. "Blocks of flats in private ownership usually suffer from patchwork management arrangements. With Build-to-Rent, everything is integrated. There is one manager for the whole building. Staff are not only from the world of housing but also from hospitality, in recognition that it is a service industry." Just over half (51%) of private renters are under 35 years of age and 54% have no dependents, and so are unlikely to get social housing. (British Property Federation).

We recommend reading the summary report by Addleshaw Goddard:

https://www.addleshawgoddard.com/globalassets/sectors/real-estate/build-to-rent-report--funding-britains-rental-revolution.pdf

Private renters prefer shared ownership

ReSI REIT's focus is shared ownership homes

A report commissioned by Heylo Housing (quoted in Property Week 13th October) showed that 78% of the 700 private renters polled stated they preferred shared ownership over renting. We note that shared ownership usually entails some restricted criteria and engagement with social housing providers, nonetheless the survey's overwhelming percentage preference is of note. Shared ownership rents are usually sub-market, but only modestly so.

Private developers as well as Housing Associations

Elsewhere in this document, we refer to Government funds set aside to enhance development of shared ownership assets. Of the 7,728 affordable homes delivered in 1Q17, 39% were for shared ownership (National Housing Federation). Help to Buy is widely publicised. Shared ownership might benefit from a similar campaign, though it is important to note that the former is an equity loan whilst the latter entails some subsidy. Some property developers offer their own shared equity schemes, as it helps them sell the homes they have built. Taylor Wimpey, for example, has offered a scheme called 'easystart' which provides first-time buyers with an equity loan of up to 15% that must be repaid within 10 years. There are advantages in private-sector tenancies lasting longer than the average three years or so that is currently the case. Shared equity would encourage the home to be treated as something the occupier treated as his/her own.

A proliferation of ownership types is here to stay

Our commentary is that the forms of ownership of old – namely, owned, market rent and subsidised rent, are multiplying to a more complex set. The complexity is a mechanism for attracting more varied forms of investment into homes and for those homes to create more sustainable communities.

hardman&co

Purpose-built social-rent residential

Housing Associations are large and expert, but their debt has risen

Housing Associations are excellent partners for fresh, private capital

As of 2016, there is a new owner- and new investor-landscape. HAs play a large part, for example L&Q's plan to develop 5,000 homes a year, 50% of which are classed as affordable. In 2016, L&Q delivered 2,552 of which 1,536 were social and affordable homes. As example of another large HA, Places for People, states that, in 2016/17, 1,519 new homes were built and acquired: its pipeline currently stands at over 16,000. Planning requirements encourage social rental properties to be included when private developments proceed. However, there are a number of reasons (see page 27) why the main developers, Housing Associations, are welcoming new capital from fresh, private, sources. This is good news, bringing in money directly to developers who have long-standing expertise.

- Housing Associations are large, expert developers in this (and other) arenas.

They have 'put their shoulder to the wheel' but their debt has risen

- They have expanded and their gearing (loans to reserves + capitalised grant) has gone from 40% in 2006 to 41% in 2011 to 43.5% in 2015 and to 48% in 2016 (Source HCA).
- They are motivated to find ways to attract outside, risk capital. This can be via jv developments. This REIT sector is NOT about that at all. It is through investing into the Government-backed rental income stream through long leases with the Housing Associations; through forward-funding of new-build and through creating new assets which replace ones significantly more expensive to run and with worse occupier outcomes. Examples of that are Supported Housing (see page 29).

How to invest in this infrastructure asset: Social housing REITS floated

These are INFRASTRUCTURE style REITs

Social housing REITs are likely to track the RPI, inflating the rent stream rather than matching private housing house prices

This asset class is social infrastructure. In most cases, the rents are not tied to the open market and thus both income streams and asset valuations are not directly linked to 'mainstream' housing. There are two exceptions. One is the segment of 'general needs' social rent housing where rents are nearer 70%-80% of open market rates, fixed at levels with reference to the open market. Some of this sub-sector within the 'general needs' component is likely to attract investment from some tain of the REITs that we cover, but not in a particularly significant volume. The second segment is shared ownership – the focus of ReSI REIT's investment mandate.

In November 2016, the first-ever REIT dedicated to social (or indeed any) residential assets floated, raising £350m. Now three other REITs have been launched.

Civitas Social Housing REIT launched a £250m fund raise late in 2016; it was oversubscribed and raised £350m - £302m has been raised subsequently. 75%+ of these funds are invested in dwellings for tenants with specialist needs – selecting investment requires due diligence; but, once this is done, real value is added (and fresh capital for the vendors).

The second fund to invest in social housing is Residential Secure Income, which raised £180m and then bought Registered Provider (RP) assets - funded by long-term index-linked debt. The main asset class is shared ownership which is a long term market-level rental. It also purchased some social rent assets. The Investment Manager is a subsidiary of TradeRisks which provides corporate finance advice and debt funding (to the tune of £10bn in the past 16 years) in the sector.

The third social housing REIT, managed by Triple Point, focuses on specialist-needs tenants. It has expertise in the sector, particularly with public sector leasing.

The reasons for the new and significant demand for money in this sector over the past year

Forward developments are clear and simple ways that REITs can deploy fruitfully

1. Developers of new social housing assets welcome forward funding – just like in other sectors (e.g. the primary medical properties sector).

The REITs seek to invest in robust assets but also to benefit from a judicious deal flow. Assets usually have been purchased or conditional agreements have been reached – often the REIT seeking long-term, strong income will achieve this through forward-funding new developments. In this sector, many developments (and all the individual assets) are small in terms of capital market real estate norms within the commercial sector. Thus, the developer of these new assets will need to take expensive project debt or fund it through its own equity. It cannot go to capital markets directly with any ease or efficiency, unless the developer is so large to be either quoted publicly or have substantial quoted or private-placement bonds outstanding. But the REITs can sign long-term, standardised contracts and the developer has no concern about 'covenants' regarding publicly-quoted REITs.

2. HAs are constrained from raising equity, have increased debt and are concerned about recent and possibly future political and legislative changes.

Since 2016, a new regime of mandated rent reductions (of 1% pa for four years) has been put in place. (This excludes specialist supported areas). This neither encourages nor facilitates taking on new loans. Many HAs are not taking on more debt.

This is not without risk – but this is a further value-add from the REITs' expertise

Post the 2015 election, it was made clear by the Government that Local Housing Allowance payments will continue at the current level. These are the grants from central government to Local Authorities to help them cover the cost of social housing. We believe that the Government is not giving full surety to the social housing sector, to the Local Authorities and to the HAs, beyond 2019. So, the obligation to house priority housing list persons remains, but rent allowances paid by central government might be reviewed in the future. There is a risk that the rents' reimbursement formulae might change (the Local Housing Allowance). Further, a hypothetical Housing Association providing housing services subject to tender might lose (or be awarded a different) service contract. This could seriously impact the 25-year lease obligation. Note the 'conditional,' since there is no 100% clear indication of future policy that Hardman can determine.

For a quick summary: http://www.bbc.co.uk/news/uk-politics-41498353

Historic returns unknown, but that raises an intriguing possibility

As more transactions take place, values could rise

Though there are valuations undertaken on this asset class: transactions have been limited. As more take place, values could rise. Markets help liquidity.

Until the past year, transactions were principally limited to a change of parent entity due to mergers. The valuations have not been market-tested, we believe. This is not the environment where valuers would necessarily take risks and guess what the value might be if there were more external investment-orientated buyers. Values are likely to err on the low side.

Assets valuations were based mostly on stock changing hands through mergers of RPs

This is a new market: to date, nearly all transactions have been between RPs, so more book keeping than market values. The background to our summary, above, is as follows. There are valuation statistics for this sector as 1) The RPs publish balance

sheets and 2) have values tested for many purposes including Right- to- Buy and lender finance. However, in each case above (with the exception of lenders), the values that we would attach do not fully reflect market valuations. Balance sheets reflect valuations at which assets change hands. The majority of this 'changing hands' has been through mergers of RPs and RPs' transactions between each other.

Whilst the RPs are often keen to sell, to free funds to invest in new-build stock, there is equally heavy demand to acquire assets with this strong rental covenant.

We see evidence that asset values are rising – and, in some cases, the rises triggered by the change of ownership. The latter may often include improvement works and certainly will involve thorough inside-outside verification of specifications. At the run-up to transaction, significant due diligence is carried out and this often reveals investment fundamentals which are particularly attractive (i.e. the scope for long-term rental growth and strong occupancy demand). In this segment we outline a number of factors coming together, which give opportunities for assets to be acquired at attractive valuations.

Investors' search for yield may drive valuations in this specific residential sub-class upwards. Overall stock had been considered to be in reasonably good condition, as a result, partly, of works undertaken via the mandatory Decent Homes Standard programme of 2004 – 2010 (extended to 2012). This initiative covered matters including the structure (principally, insulation) and also kitchens, bathrooms and other repair standards. Clearly the disaster at Grenfell Tower has raised significant queries about high-rise flats, not just of the cladding but also of maintenance. There is a need for more social housing to rent and it appears there is some stock (possibly a small minority) which faces appalling issues as regards maintenance/ upgrade.

Bringing several substantial classes of new investors (life funds, overseas and REITs) raises demand - and supply is not rising fast

Significant investment is undoubtedly needed in the sector.

We see several potential positive valuation surprises for the REITs and other external investors. Bringing several substantial classes of new investors (life funds, overseas and REITs) raises demand and supply is not rising fast. Our view is that pricing historically has been more a book-keeping exercise used for transfers between RPs (including the original large-scale transfers from Local Authority to Housing Association (LSVTs).

What funds social/ affordable new building?

In summary, there are several new drivers for a rise in development of these assets.

New private capital coming into the sector - this is a new owner and new investor landscape

- RP's asset holdings generate free cash flow. Further, the large recent mergers raise efficiencies. Being not-for-dividend organisations, savings are re-invested, usually in new development. The mergers reflect changes in grant and the rent charged - and are seen by all as only part of the 'solution' to more new development.
- Government grants are set to rise post the 2017 Conservative Conference, but they had fallen significantly in the past 5 years so this will remain a gap to be filled by new private capital
- New private capital coming into the sector in 'private' funds is key.
- New private capital coming into the sector (the REITs being floated) will build to a meaningful amount, thereby making a real difference to RPs' development plans.

Supported Housing described

Supported housing, also called functional housing, provides properties with accommodation for tenants with particular requirements, the most vulnerable members of society, such as those with learning disabilities and mental health problems, and people with physical or sensory impairment. These could be older people, but typically not. A typical occupant would be supported by several social workers either part-time or on a 24-hour basis. They may have physical disabilities so the structure of the property would have specific requirements taking in strengthened framework (lifts, wet rooms etc). They may have behavioural support requirements which may require extensive configuration works.

Civitas Social Housing specialises in rental assets – the very significant structural reconfiguring is internal.

A typical supported living house

Source: Civitas Social Housing

Significant societal benefits, in people and in £ terms…..

For society (to be specific, the tax-payer as well as the better outcome for the individual), the rental cost is c£200 a week for a tenant. There is the cost of the care worker support, which usually will be more (sometimes more than 10x more than the rent). But the alternative will have been living with parents or in a larger institution. Parental care is likely to be a really good outcome but 60% of people with this type of learning disability or problem will be living with relatives aged 65 or over. The population requiring accommodation will thus inexorably rise. Further, ante-natal care improvements will also expand the relevant population. Local Authority Health Commissioners seek to move people progressively out of institutions if all parties are agreed. Smaller care settings will often enable a lower ratio of carers and the cost of carers is a large multiple of rent. Were there to be pressure to cap rents (and there is, both in the private and public sectors), it is relevant that tax-payer savings from supported housing are significant.

….. a very large sector by value

The typical methodology for Civitas is to be deeply involved specifying works, if any are required, and to monitor closely but also to offer the developer (i.e. the refurbisher) a specific purchase guarantee subject to the developer, at his cost, delivering the exact specification. This also includes expensive discussion with the care providers the occupiers and all other stakeholders. Triple Point will do this too, but, we anticipate, would also be involved (unlike Civitas) in forward funding new. Other REITs, such as LXi, are also involved in this sub sector.

We have no details of rent or capital value to gauge the size of the sector as a whole but believe it to be valued at between £50-£100bn. The quoted student accommodation sector is c5% of the value of the total student purpose-built stock. With 5% of £50bn being £2.5bn, there is more than enough scope for significant growth in the portfolios.

Seven REITs and two developers

Pent up potential: much more choice since November 2016

We now turn to the vehicles for investors

UK owner-occupation peaked in 2007, illustrating the progressive, entrenched switch toward the rental sector. Yet, until three years ago, the only meaningful way to gain exposure was **Grainger Trust (GRI)** or **Unite (UTG)**. Two student property funds then floated: providing exposure to a modest-sized residential asset. Now a variety of avenues for investment are open and working well.

Residential REITs - only £1,350m market cap which is 0.023% of the value of the whole sector

Civitas Social Housing (CSH)'s over-subscribed November 2016 IPO kick started a new sector. Even so, residential REITs' valuations equate to just 0.023% of total UK residential assets (0.07% of the value of total UK rental-occupied residential). Surely there has to be scope for more? This document concludes that there will indeed be more investment, both through REITs and via developers of new BTR dwellings.

£2.9bn market cap for Grainger and Unite alone – we therefore see scope for many more REITs and developers focused on residential

We assess four REITs **(CSH, PRSR, RESI and SOHO)** and two developers (**TEF** and **WJG**). We do not cover Grainger Trust (**GRI**) which is not a REIT or Unite (**UTG**). The former develops and invests in residential assets (in the UK, having sold its German exposure). Unite is a student asset developer REIT and manages funds. Whilst we do cover developers (Watkin Jones – **WJG**, Telford Homes – **TEF**), the rationale is that WJG and TEF are (prospectively) significant, specifically in the BTR sector, which we see as 'mainstream' as opposed to specialised student assets. Grainger Trust (**GRI**) – market cap. £1.19bn – trades at 284p, compared with the latest (March 2017) EPRA NNNAV of 295p and EPRA NAV of 338p. Being a non-REIT entails significant deferred tax liabilities. Unite (**UTG**) – market cap. £1.75bn – trades at a premium to NAV. Its latest EPRA NAV stands at 646p, with the latest share price of 729p.

Student accommodation has moved mainstream which makes the low invested capital in the broader sector appear to be a major anomaly - and opportunity

The table below lists residential REITs plus the two student REITs. This document focuses on the potential across the board for residential investments, noting that REITs in non-student accommodation have a total market value of £1,350m which is c0.023% total UK residential asset values. The three student accommodation REITs represent c5% of the value of the total UK purpose-built student accommodation asset class (Knight Frank): this document does not cover student accommodation. Although residential, its supply/ demand and rental growth dynamics are unlike other residential. There is much more scope for new money being raised in broader residential assets (on the figures, above). See also page 36 table (funds deployed).

Civitas has invested its first raise and received a further £302m in equity

In addition, LXi invests in residential but only for a minority of its assets

UK Residential REITs

REIT	Ticker	Main asset class	£m raised at flotation	£m further raise	Date of float
Civitas Social Housing [1]	**CSH**	Social	**350**	**302**	Nov 16
Empiric Student	**ESP**	Student	**85**	**520**	June 14
GCP Student Living	**DIGS**	Student	**70**	**415**	May 13
The PRS REIT	**PRSR**	Open mkt housing	**250**	**0**	May 17
Residential Secure Income	**RESI**	Shared ownership	**180**	**0**	July 17
Triple Point Social Housing	**SOHO**	Social	**200**	**0**	Aug 17
Unite [2]	**UTG**	Student	**8**	**570**	July 99

NOTE [1] Civitas £302m C Share Nov 2017. [2] Unite also holds investment funds   Source: Hardman & Co

We include Empiric, GCP, for comparison, both being residential. However, student accommodation is a different asset class, and is not analysed in this document.

How to invest

This document focuses on the REITs but there are other opportunities in residential development excluding the 'traditional' model of selling units to occupiers and Buy-to-Let to let investors. End-investors in purpose-built private sector rental blocks are long-term institutions, meaning that developers do not rely on the more cyclical confidence of the private housing-for-sale market. A large developer of this stock (Watkin Jones: WJG) achieves its targetted 20% gross margin consistently.

Developers

Two developers – which are expanding into BTR

Developers, **Watkin Jones (WJG)** and **Telford Homes (TEF)**, with the appropriate track record of expertise, are putting together land buying and design skills that they already possess in-house, in order to provide long term investors with a 'turn-key' secure asset solution in BTR: BTR, not relying on a sales model, is more predictable.

REITs

Four housing REITs (there were none until last November

REITs such as **Civitas Social Housing (CSH)**, **The PRS REIT (PRSR)**, **Residential Secure Income REIT (RESI)** and **Triple Point Social Housing (SOHO)** invest in residential assets which are rented to (respectively) social and specialist social rent tenants; to open-market 'private' tenants (usually families and focused on the North of England and on the Midlands); shared ownership; and various social housing tenants. REIT investors have to pick the right sub-sectors – which, we consider, comprise i) new-build private rental blocks and ii) specialist niches where the specific REIT expertise is paramount. This could be in supported social housing, in shared ownership or in specialist BTR segments. Shared ownership offers lower yields but more exposure to residential values rising, we believe.

The individual stocks

CSH: A specialist area with net initial yields at acquisition of c. 6%

£250m initial fund raise expanded to £350m at November 2016 IPO and now a £302m follow-on

Civitas Social Housing (**CSH**) purchases extensively reconfigured houses and 'supported housing' properties, providing accommodation to vulnerable members of society (comprising over 75% but more likely 90%+ of the total assets). Vendors are HAs, care providers and others. CSH undertakes extensive due diligence on assets, tenant-demand and rental levels. Income derives from long-term HA leases. Vendors benefit from funds for new social housing development. CSH purchases on net initial yields (full-maintaining) of c6%, with income inflating at CPI or higher. Note that the initial IPO target was increased to £350m, as a result of strong demand. A £302m C share issue was completed, with the shares now trading.

K&C REIT (KCR) is an existing residential REIT with shareholders' funds of £5m. On 24th October it announced it was seeking £150m of further equity. See page 35. Fund-raise has not been confirmed, thus KCR is NOT covered in detail in this document.

A different approach, with strong chances of good capital gain - as well as income

LXi REIT (LXI) is also NOT covered in detail in this document but is important to reference as 1) It holds 24% of its assets in supported living and 22% in care homes. 2) It has a different approach to the other REITs discussed. Not being a dedicated sectoral investor, it can more easily choose to re-balance over time. Nonetheless, we would never expect it to buy, other than on long, secure high covenant leases, but it might buy sectors which are not (yet) mainstream to attempt to achieve three aims. 1) Buy on yields which, on their own support, a good (5%) dividend; 2) Buy in areas prone to yield compression; 3) Buy individual assets where leases are long enough to dispose of advantageously after 5-10 years, with still 15+ years left on the lease (but after several 'up-only' rent reviews) thereby optimising their attractiveness. We believe this REIT (floated in 2017) will garner further, positive, attention as its track record develops. 23rd November results showed strong NAV uplift to 105.1p (end September), probably high now with further deployment.

PRSR: projected 6% dividend yield – more than peer group

The PRS REIT (PRSR) forward funds developments of new BTR estates. The forward funding price discount, efficiencies of scale and the geographic focus underpin its target of 6% dividend yield (fully invested). Revenues and costs are readily modelled. Long-term rental growth is likely, but far from guaranteed. Importantly, this is less 'required' as a component of the returns, given the good net initial yield likely on the assets. We see real rental growth as a potential addition but not a core element of the model, enhancing the model's sustainability to shareholders. Dilapidations (and the knock-on to re-letting across the block) are managed but are a risk. There is also a risk if third parties over-supply competing properties, either new or second-hand.

RESI: Shared ownership and also social rent

Residential Secure Income (RESI) The 12th July IPO raised £180m of equity. It is finalising on £250m shared-ownership portfolios and has completed purchase of a £100m retirement portfolio. ReSI's strategy seeks to deliver an inflation-linked target of a 5% annual dividend (total annual return of 8%+). Focus is on UK social housing: shared ownership, market rental, supported needs and sub-market rental housing. It invests in portfolios, which are fundable by long-term matched investment grade debt, potentially through forward-funding or recycling standing stock. ReSI is managed as a subsidiary of TradeRisks Limited, a leading adviser and debt arranger to HAs and Local Authorities, which has raised over £10bn in the last 16 years.

TEF: risk profile and cash generation significantly enhanced

Telford Homes (TEF) is a residential developer. BTR now* is 77% of revenues, v. 24% a year ago. This facilitates substantial growth. The pipeline was* £1.5bn v £627m four years ago. Since January 2016, it has contracted to four sites dedicated to BTR. There is notable benefit from higher ROCE (quicker capital turn albeit at lower margins). * Note: results are due to be published as this document goes to press.

So growth can be accelerated significantly and sustainably

Over the next two years, market consensus sees 24% CAGR sales growth, 25% PBT/EPS growth. The full-year March 2017 results showed £546m forward sales, equating to 70% of cumulative two years' forecast sales. Telford Homes will be less dependent on cyclical residential sales, whilst bringing cash flow forward and keeping forward sales growth visibility high. Telford Homes is paid a deposit by the BTR investor institutions. The construction is forward-funded, with the investor paying regular sums through the construction phase. "As such very little, if any, equity is used during construction and no debt is required." (Latest results statement).

SOHO: Specialist supported social housing

Triple Point Social Housing (SOHO): at least 80% of the assets owned by the REIT will be 'supported housing' properties, providing accommodation for vulnerable or elderly members of society, such as those with learning disabilities etc or mental, physical or sensory impairment. Such properties owned by REIT will be leased to an Approved Provider (such as an HA) and a care provider. Net initial yields in this sector typically range from 5.5% to 6.5%. £48m has been acquired to date, including a £17.9m seed portfolio. Triple Point's flotation took place on 8th August.

WJG: Has a strong record developing student blocks, translating to build-to-rent. The latter has greater growth prospects. Very much not a 'crowded' market

Watkin Jones (WJG) is principally a developer and manager of UK student accommodation but, in the past 18 months, has expanded to develop for repeat, institutional buyers and it manages private BTR In fact, six BTR schemes are currently targeted for delivery over the period FY19 to FY21 – on similar gross margins and returns. In the six months to March 2017, it achieved a 21.8% gross margin compared with 16.1% for 2016. Its expertise is in demand and is hard to replicate.

The assets' end-investors are long term funds. WJG's proven ability is welcomed: it undertakes all work in house, from site-sourcing ('on-risk') through to design (this is a new asset class so fit-for-purpose design is important) and to construction, fit out and subsequent management. This proven seamless process from site find to operational project underpins, we consider, its returns. Visibility is strong and, now that BTR is part of the offering, growth potential is particularly strong.

Areas of future interest

A number of sub-markets within the UK residential market are absent from the current portfolio of residential-focused REITs.

Build to rent (BTR) flats

Flats as opposed to houses – an opportunity not yet addressed

We consider there is every opportunity for the forward funding of BTR 'flatted' developments. The yields available should, in the appropriate locations (where the BTR development could unlock a site early), exceed the figure required to achieve – with some financial gearing – a c5% sustainable dividend yield at the issue price.

PRS REIT has stated in its Prospectus: "The Investment Adviser believes the construction of PRS housing (at scale) will be a key part of any measures taken to address the perceived shortage of housing in the UK. It accelerates the delivery of new homes which is in line with central Government and Local Authority targets for new housing. As a result, the HCA has already supported the Sigma Group (manager of PRS REIT) and has committed to support the Issue with a direct investment in the Company of 9.99% of the Gross Issue Proceeds." We have discussed the BBTR market in this document and the only REIT addressing this, to date, is the PRS REIT. The PRS REIT invests in houses (as opposed to flats). The overwhelming majority of BTR in North America is flats and in the UK, the same is anticipated.

Residential Secure Income REIT, within its remit, may purchase some BTR assets. This is, we understand, low on the list and the 21st September update confirmed that £250m worth of shared ownership housing and £100m of general purpose social homes for rent are under due diligence, the latter now concluded.

Age-restricted accommodation

ReSI has recently announced a significant purchase in this sector and we anticipate others to invest much more. Yields are attractive and tenants have excellent payment profiles. A Demos paper published recently, calculated a demand for 30,000 new retirement properties a year v the 7,200 a year being built. "25% of older people say they would buy a retirement home but there are only enough for 2.7% to do so."

Age-restricted Housing is a concept where an age restriction is placed on occupants (usually in the developers' planning consent and usually at a minimum of 55 or 60 years). There are no other defining features; this is distinct from sheltered housing. Here, the assistance is generally a monitoring service through a call system to an off-site service or to an on-site warden (or officer). No direct care is provided but assistance will be given to call in care or medical assistance if required. Help may also be offered in choosing and making the transition to care accommodation.

Age-restricted housing is currently purely a develop and sell model, fully aligned to the private housing market. Thus, the developer has no interest in the scheme beyond the last sale. If any are developed for rent, we have not found the details. However, this is exactly the type of market which would prove attractive for BTR. The efficiencies are there, as per non-restricted accommodation.

Renters (more than buyers) may look at the specific development and not compare what it offers with general housing around it. That can create value for the developer

In addition, and most significantly, the element of social interaction with other occupants is a key feature. Well-designed developments, built and laid out to retain attraction, will likely pay attention to how each apartment 'works' but also to how the development as a whole 'works' socially. There are many direct lessons to be shared. It might be too far to assert that renters would be looking at the specific

development and not comparing the offering with the local housing market at all. But this would be more likely to be the case in rental rather than in Build- to-Sell.

Age-restricted developments in the private sector can either be relatively up-market (Beechcroft and English Courtyard) or on similar pricing to the mainstream market. The attraction for active elderly is to secure the opportunity to live with people of a similar age, whether there are shared facilities or not. They will probably downsize from larger-sized family housing, releasing financial equity. The downside is that, in re-sale, the buyer has to be over the age minimum and usually renting is not an option. Most are designed with a bathroom but showers are increasingly the core product. They tend to be designed with additional space to allow for wheelchair or walking aid manoeuvrability and full wet room facilities. Door widths, corridors andsockets tend to be more generous. A balance between the negative of a restricted market for resale and a product designed to attract that targeted audience is essential: this does heighten, though, the risks of obsolescence.

Age-restricted occupants certainly do not correspond directly with the sub-set of citizens receiving social care benefits. Nonetheless, it is important to keep in mind that 55% of Local Authority spending on local services (2015/16) was expenditure on social care (source IFS).

Sheltered housing and retirement villages

So little is available to rent privately that a latent demand has built up

The warden (or officer) assisted market is almost exclusively for private sale OR social rent. A few apartments are rented within developments originally sold to private buyers. Often, they have become rented through an inability to sell – so this is sub-optimal, particularly in terms of maintenance servicing the tenant. Being a tenant is however attractive. It obviates the need to sell at a time potentially of stress within the vendor's family. Selling may take some time and the monthly service charges keep having to be met. Renting, by its nature, also helps in terms of 'try before buy' and in terms of ease of moving to a new location, perhaps to be near family.

The large capital employed in villages may point to a REIT rather than a developer-funded model

Turning to retirement villages, the develop to sell model has constraints. Many developments will be large enough to have significant infrastructure costs. Some of that will be 'sunk cost' (as with infrastructure in large private for sale developments, like roads and utilities). Interestingly, some may be assets which generate income – sports facilities and restaurants. This may be more suited to REITs looking at income streams and with large amounts of capital to invest.

Acquisitions from SPVs with less tax attractions than REITs

This attribute of REITs creates an advantage to their 'forward funding' of developments

This last topic is not so much 'future interest' as a fundamental REIT benefit being highlighted by the assets acquired via a K&C REIT (KCR) major fund-raise. A major point of the REIT regime (see page 5) is to achieve tax-efficiency. It is intrinsic to all REITs that they will be at a tax advantage to non-REITs regarding any profit, including development profits. (This analysis excludes capital allowances or carried forward losses). The attraction to the (non-REIT) developer will probably be more ROCE or ROE, than the net initial yield of the assets.

K&C REIT seeks to fund non-REIT SPVs – just another way of looking at forward funding third party developers

Telford illustrates this point, with its lower gross margins but attractive ROCE in the BTR development division. Several REITs favour forward-funding of developments by third parties, with PRS REIT at the forefront, but many others (including Triple Point) consider this is intrinsic to their business plan. Telford points to its business plan actually benefitting (as a developer) even with reduced selling prices. Nonetheless, K&C REIT has broadened this existing sub-sector focus on forward funding into a business stream from SPVs. We presume (prior to more detail being made public) that this is using K&C REIT capital to accelerate the capital turn of the SPVs. This

process levers REIT capital into a value uplift from day one and it is common in many REITs.

K&C REIT

On 24th October 2017, K&C REIT (a small quoted REIT which is changing its name to KCR Residential REIT) announced a proposed new Director, Duncan Walker, ex Helical, and announced a placing to raise £150m, with a pipeline of assets under due diligence of c£400m, specifically in private rented. K&C REIT stated "The Company will target SPVs with unrealised capital gains where REIT status can confer a commercial advantage to the Company. A capital gain which accrues to a REIT in respect of a property that is used for a Qualifying Property Rental Business, including gains already accrued at the point of acquisition of that property, is exempt from Corporation Tax. Therefore, a REIT can acquire a rental property and on the subsequent disposal of that property, there will not be a liability to Corporation Tax on any gain realised on that disposal. Acquisition of SPVs: the Directors and Proposed Director consider that the tax exemption afforded to REITs will enable the Company to achieve a yield on its portfolio that is higher than would be achievable by a non-REIT company or an individual." Admission of the new shares was due on 27th November, but has been delayed, pending progress on pipelines.

The REITs' focus and their ability to evolve its sub-sector weightings

In the future, more funds will target the sector AMONG OTHER sectors

The 'constitutional' ability to evolve a REIT's sector weightings enables the managers to consider taking profits in a 'hot' sector and to re-balance to a sector yet to achieve its proper potential. There is one REIT (LXi) which holds significant investments in one sub-sector (supported living and care).

As time progresses and the residential segment becomes accepted as more mainstream, we anticipate that other REITs, which are not 100% dedicated to residential, will take positions in residential assets.

Further regarding valuation methodology

An art, but…

JLL has revalued Civitas' assets since their purchase, although the initial portfolio subject to this revaluation was of a modest size. Much discussion has ensued regarding the correct role of valuers in assessing portfolio premia. This is in part a question of semantics. Has the buyer simply 'bought cheaply', probably taking benefit from its 'buying power'? In all cases, the cost of buying includes Stamp Duty and so second-hand 'standing' stock faces a 5% tax cost unless an SPV is being bought where a 0.5% tax rate applies. The 'buying power' would usually result in a 5% tax rate having to be paid by the vendor/developer. Further, the mere act of buying AFTER significant due diligence in a specialist area would indicate that the asset has tried and tested quality. This 'endorsement' would add value.

….the act of buying post DD, may add value

We would like to see any valuers' 'portfolio effect' on valuation be quantified explicitly

Asset valuation is, we consider, an art in the cases where a REIT puts together a portfolio which is both difficult to source and 'works' by creating a robust income stream. In particular, portfolios made up of smaller lot-sized assets which require effort and due diligence in each individual case, are increasingly attractive to potential third-party buyers who are interested only in large portfolios but prepared to pay more. Nonetheless, it might be considered that the premium, for a quoted stock, should be reflected in the share price, rather than in the external valuers' assessment. A good example, we consider, would be primary medical properties, where there is an established market and larger assets/ portfolios do trade at finer (higher-priced) net initial yields. But the NAVs for the three quoted stocks (from the external valuers) do not reflect any portfolio premium. We believe that investors (via the share price) should be responsible for assessing the 'portfolio premium', but as long as this element is made explicit, there is no problem.

The REITs

We summarise each residential REIT. Further, pp. 44 and 48 summarise the position of two developers – **Telford Homes** (TEF) and **Watkin Jones** (WJG) – who are expanding into built-to-rent. **Unite** (UTG) is not included (it holds a number of JVs).

Residential asset REITs

REIT		Price (p)	Historic year EPRA NAV (p)	Share price/ Historic NAV	Historic / prospective * div (p)	Historic/ div yield	Asset net initial yield %	£m Market capitalisation
Civitas Social Housing	**CSH**	110	110	1.00	5.0 *	4.5%	6.0	687
Empiric Student	**ESP**	89	106	0.84	6.0	6.8%	4.2	537
GCP Student Living	**DIGS**	142	139	1.02	5.75	4.1%	3.8	546
The PRS REIT	**PRSR**	103	98	1.05	6.0 *	n.a.	5.3	257
Residential Secure	**RESI**	100	98	1.02	5.0 *	n.a.	3.5	180
Triple Point Social Housing	**SOHO**	103	98	1.05	5.0 *	n.a.	6.0	206

NB: ESP Update of 23/11/17: 2018E dividend cut to 5.0p, a 5.6% prospective div yield

Source: Hardman & Co and Companies

Civitas Social Housing

Civitas has a focus on specialist-need social housing. It has made a strong start; its funds invested now total more than the £350m IPO raise

CSH made a strong start post-IPO, as the first residential REIT floated (student accommodation being a different asset class not analysed here). CSH acquires specialist stock yielding at just over 6.0% but requiring deep due diligence. Its NAV was 110p at the end of September 2017.

The PRS REIT

The PRS REIT benefits from forward funding agreements

The housing stock being acquired (forward-funded) is – to date – a unique asset sub-class: it is aimed at houses rather than apartments. Houses for families may prove to benefit from longer tenancies. The geographic locations are in the North of England and in the Midlands, so rents should not be over-stretched against family income.

Triple Point Social Housing

Triple Point has a focus on specialist-need social housing

This REIT acquires specialist stock requiring deep due diligence and benefitting from yields of just over 6.0%.

Residential Secure income

Residential Secure income is a social housing investor and comes to market with a large pipeline

This REIT acquires shared ownership, social rented and other properties. The Fund Manager has entered into negotiations to buy further portfolios valued at £250m – a relatively high figure for a REIT at this early stage, so the figure in the table below should rise significantly, shortly.

UK Residential REITs (ex-student REITs) – next event

REIT	Ticker	Next event	Invested to date	Date of float
Civitas Social Housing	**CSH**	March update	£302m	Nov 16
The PRS REIT	**PRSR**	End Dec Q4 update	£135m	May 17
Residential Secure Income	**RESI**	13/12 AGM; Mar res'lt	£100m *[1]*	July 17
Triple Point Social Housing	**SOHO**	Mid Jan update	£48m	Aug 17

Source: Hardman & Co estimates and Companies

[1] NB: Invested to date includes forward- funded, excludes heads of terms, where ReSI has exposure.

NB: K&C REIT is in the process of a fundraise

Civitas Social Housing (CSH)

110p and £687m market cap

£350m raised – IPO date 18th November 2016

£302m C share issue recently

Deep specialism creates value arbitraging risk

CSH invests 75%+ (we anticipate 90%+) in 'specified needs' social housing: the rest is deployed in 'general needs' social housing, on 10 (mostly 25) year-plus leases. Weighted average unexpired lease term is 24.3 years. The Specified Needs stock is being acquired on yields of 5.5% to 6.5% (higher than General Needs social stock), and this premium is interesting in two regards. First, it is a strong driver to fund cash returns. Secondly, the yield premium is there to reflect the perceived risk of exposure to assets with alternative use values at lower levels; hence, the need to invest to avoid obsolescence longer-term. We question this latter concern as the need is for significant specific requirements to the buildings' long-term tenants. Underlying income is thus unlikely to be a problem. Importantly, all the maintenance risk devolves to the lessee. Buildings are thoroughly refurbished pre-purchase.

Upgrade works at the time of purchase

But Civitas' due diligence via deep expertise (e.g. ex Local Authority commissioners being on the team) raises knowledge regarding the physical property (often including upgrade works at the time of purchase), the ongoing management and maintenance services, local tenant demands and hence the true long-term asset risks. The assets are in nearly 90 Local Authorities. Not only does this give it great scope to be confident knowing the local details and 'quirks' for many UK locations, it also results in the Local Authorities' knowledge of ownership/ vendors helping Civitas' understanding of where to look to buy. So Civitas is buying into a market which is undeveloped and where most buyers are wary of the pitfalls in an area where they might have less expertise. JLL revalued the initial assets upwards.

Deployment update, 23rd November results

Specialist but large so Civitas' deep knowledge can be deployed in size

More than £500m assets have bene identified that may be bought in the coming year, of which c. £100m 'near term' (as per the results statement). Civitas is buying assets within an asset class that we estimate to comprise c £100bn of market value. Investors have been kept well-informed via 30 announcements on acquisitions and the 31st October update that confirmed £302m had been invested. The typical property costs between £0.5m and £1.2m and location is throughout England including London and the South-east (with some in Wales). There are (31st October) 311 properties, 1,935 tenants, 10 HAs, 85 Local Authorities and 53 care providers. In September, properties with a value in excess of £160m were, at that stage, under exclusivity/detailed heads of terms. Debt is being taken on now, at low rates.

C share

On 28th September, a 'C' share funding was announced, with good momentum on deployment. £302m of new equity was raised (up to £350m was sought). These shares will pay a 3% per year fixed-rate dividend, and convert at the earlier of 12 months from admission or when 90% of the issue proceeds have been invested.

Further asset analysis

Vendors: Housing Associations, care providers, others………

Vendors comprise Housing Associations, private individuals and others, but importantly, also include care providers. For obvious reasons of potential conflict of interest and risk, there is a trend for care providers being dissuaded from being the underlying property owners. HAs are motivated to sell (their gearing ratios and their desire to develop new stock), but so too are the care provider asset owners.

….all for their own reasons are motivated sellers

Yield premia on acquisition, combined with Civitas' in-house expertise and the due diligence undertaken on a property-by-property basis, offer scope for good assets to be acquired at valuations which could see the yield tightening in the future. Indeed,

in its first set of results to end March 2017, EPRA NAV was 4.1% higher than the IPO NAV. This equated to a rise of over 13% in the £106m assets deployed since the IPO, an encouraging start. NAV now approaches 110p.

Assets are held on leases

Civitas is not directly exposed to occupier-tenant rental income as its assets are held on leases. The underlying dynamics are however crucial for the value of the assets at the end of the leases. Specified needs housing rents are not subject to the 1% pa reduction cap. Their tenants tend to wish to stay indefinitely and certainly over ten years. The 2014 Care Act puts a statutory requirement on Local Authorities to reduce reliance on institutional-based care. Most of the Civitas occupants have their own front door. Demand should remain high (especially as the population – the home carers, relatives – ages) and tenancy turnover is low.

Assets are managed by HAs

Assets are managed by HAs. Civitas needs to (and does) ensure the long-term demand for the property and that the management is in place; both are conducive to a strong valuation at the end of the 25 to 40-year lease that Civitas enters into with the asset owners. The strong team, good initial net yield and the initial revaluation all point to real value being created here.

Plenty of room for several £bn investment

The investments that Civitas makes are intended to enhance the lives of those people who are able to benefit from the availability of appropriate, high quality housing whether of a general nature or as a base for the provision of more specialist housing and care. Improving the ratio of carers to occupants (which has been achieved by Civitas) significantly reduces public spending. Civitas intends to play a broader role in the housing and homelessness environment – the remit is significantly to create public sector financial benefit and benefit to the occupants and this may over time – with care - be broadened beyond learning disability etc into supported housing. We have shown that there is plenty of room for several £bn of investment into supported social housing in any case.

Civitas may invest in 'mainstream' social housing

Civitas Social Housing REIT may invest in 'mainstream' social housing. This is a market with substantial ongoing changes in ownership of assets – as a result of consolidation of anumber of social housing owners (HAs or RPs if Local Authorities are included). It is unclear what level the current deployment has reached. There are 1,650 HAs but most are small and at the upper-mid tier. Some substantial mergers and take-overs have occurred. In December 2016, L&Q and East Thames joined forces to manage over 90,000 homes. Affinity Sutton and Circle manage 125,000 homes post their 2016 merger.

Assets' rental profile has great strength – JLL states that 0.7% of rent receivable is provided for as irrecoverable debt (JLL, Civitas prospectus). Importantly, the largest 100 social housing landlords faced more than £700m gross rent arrears in 2016 (source Mobysoft). This does not affect CSH directly given that the leases are with the social housing provider. The UK mainstream social housing rents are mandated to fall by 1% pa from April 2016 for four years (supported/specified housing needs are exempt). The rent reductions are a key factor behind consolidation of ownership in the sector – motivated by efficiency measures. JLL reports "There are reported to be about 25 sets of merger discussions…"

The ownership changes and consolidations lead to a number of factors: we would highlight two. The completion of social and affordable rent homes delivered by all RPs rose by 67% to 40,970 units in 2014/15, with shared ownership up 62% at 10,986 - from a very low base in the previous year. There were further rises in 2016. Encouraging as these rises are, they take completions only slightly above the 2012 figure. The recent upwards direction is the positive point. The Office for Budget Responsibility has suggested that around 14,000 fewer 'affordable homes' will be

built as a result of the changes to the rent regime, but this is before taking into account the new private capital being invested in the sector (from Civitas and other new REITs). Assets in this REIT are deployed to facilitate the RPs' development pipelines so are welcomed by the vendors.

Risk reward

No real correlation with mainstream house prices

- 20 / 25-year leases, all within the regulated social housing sector, on CPI or CPI +1% adjustments. The REIT has entered into long-term commercial contracts and the RPs take the risk of voids, costs and rental levels. Clearly, Civitas is taking a calculated risk regarding the covenant (the ability of the lessee to pay the monthly commercial rent stream to Civitas) but this is an A category sector.

This sector needs significant due diligence, especially with the public sector seeking the owner to be 'efficient' in refurbishment and in rent levels

- Extensive due diligence is undertaken on both underlying rents and service charges that the leases are affordable. That due diligence creates knowledge of tail risks and upside, is directly relevant to the following point.
- Detailed work with the policy of Local Authorities and housing officers is relevant but primarily for the residual value at the end of the lease. Rents paid to tenants of specialist housing (Housing Benefit) comprise nearly 100% of the income on the house (again, this is only pertinent for the residual value at the end of the lease). Policy changes have benefitted this type of housing – i.e. they are well-located (usually centrally) positions and specifically are not institutions, out of which tenants are tending to re-locate. However, policy regards more purpose-built or amenity is of direct relevance at end of lease.
- On a yield basis, there is scope to benefit further from revaluations, as specified needs housing is bought on yield premia. Note, there is no development risk.
- This also implies that, were valuation yields to shift to a more bearish stance, 1) the higher initial yield, mathematically, would give protection. 2) Tenancies are all linked to CPI, which is a significant feature. 3) Covenants are A class.
- Low correlation exists v. the general residential and commercial real estate sectors.

Investment case

Good assets and ones which generate long, strong income streams

Interims showed excellent progress: 2.25p dividends have been announced to date. The contracted rent roll is £17.4m. Civitas team's expertise in selecting robust assets has been vindicated by good revaluation uplifts on the initial acquired assets. This underpins the points relating to residual values 25 years out, but it is there that we consider the most material risk lies. Clearly, discounting that risk back to a NPV strongly mitigates this concern. Further, we consider the end-risk is low in reality.

High starting yields, inflating above CPI

For Civitas' acquisition team, significant due diligence is required – again, principally as regards end-lease risk and also reputational risk if (for example) assets prove to be over-rented or suffer some operational strain. The higher costs of the team are focused on the acquisition screening so they do not embed an inefficient management cost base. By the nature of long leases, the income stream is CPI / CPI +1%, as opposed to being closely correlated to private rental income streams. Thus, it is defensive and uncorrelated - with scope for an element of NAV revaluation above the income increases. Within a social housing sector valued at c£300bn, the value of the market for 'specified needs' social housing is under 25% of this figure, we estimate. The target market is very large - still.

2.99% 10-year fixed debt facility was secured (Scottish Widows) in November 2017.

The PRS REIT (PRSR)

103p and £257m market cap

£250m raised – IPO date 31st May 2017

Forward funding will predominate

Higher rental yields, lower rental growth and lower beta

Investment managers are Sigma Capital. It has a heritage in regeneration and has delivered over 3,500 houses across all tenures for Local Authority partners. The PRS REIT is targeting (not forecasting) a 5% dividend yield in the period to 30th June 2018 and, once stabilised, a 6%+ dividend yield (at issue price). We see their investment, construction and strategic input as a positive support to volume delivery. It is stated by The PRS REIT that "Approximately 1/3 of the REIT equity will be used to purchase completed assets, the balance to forward fund development within the REIT itself."

House/family-based, full open market affordable renting

We are encouraged by the family-rental focus, a large market. 29% of the rental market in 2003/4 was families with children – now the figure is 37%. 38% of Sigma's tenancies have dependents. Families tend to place greater emphasis on modern fit-for-purpose stock given the likely longer tenancies. To date, 89% of stock acquired is made up of houses (two, three and four-bed). The average pipeline price is £146,000, below all the various measures of the average UK house price.

The Manager has a track record of enabling major regeneration sites

Sigma has focus on the North of England and Midlands. It makes the land element excellent value but also unlocks land supply on sites which would be seen as marginal by 'traditional' developers. This is because PRSR turbo-charges developers' ROCE through providing it with early equity. It is no accident that The Homes and Communities Agency (HCA) subscribed for 9.99% of the issue at time of flotation.

Data suggest the rents outside London are more resilient in a downturn (were 2010 to be replicated). However, the medium-term supply/ demand characterises in the focus regions are less robust than in London and in the South-East.

Deployment update

The Manager already has brought 3,500 homes into rent

The equity capital raised at admission is expected to be fully committed in 1H18. Sigma, the Manager, is set to continue to be shown a strong pipeline because it unlocks sites for development. This stock is developed right at the site's start. Stock has been bought from Sigma Capital Group (parent) and from forward-funded construction by Countryside and Keepmoat, both experienced developers.

Good roll-out

The total value of PRS assets acquired, forward- purchased or under construction at the end of September was in excess of £134.6m: there were 926 new rental homes with an Estimated Rental Value of £8.4m per year. The REIT has entered into forward funding arrangements with the Investment Adviser (Sigma Group) to acquire a completed site (with more to follow). To date, Sigma has delivered and let c. £240m assets on 30 sites, all without cost over-run.

Further asset analysis - lower beta, lower growth

Whilst bearing in mind the positive factors of premium net initial yield and likely lower rental growth volatility, medium-term rent growth may be only modestly positive. In the past, it has matched but not exceeded CPI. So, one obvious risk is that the target regions may be subject to the development of new stock and, if demand is only moderately strong, bad decisions, made by other developers, risk impacting PRS REIT returns. This is mitigated by the housing (v flats) focus. A recent Savills report states "The vast majority of the pipeline of stock coming forward is comprised of flats, while there is clearly high demand from young families. This creates a major opportunity for investors offering rental product targeting the needs of families in appropriate locations." In other words: mostly houses.

Construction framework with two established developers, but track record is really with one

Construction framework agreements are in place with Countryside Properties plc, Keepmoat Homes Limited and Keepmoat Regeneration Limited – these give The PRS REIT land bank access, construction resource and fixed priced construction. Further, PRS REIT states "Strong Local Authority relationships – land delivery and planning." It states its focus will be the major conurbations of England, following main train and road infrastructure (some are near the proposed HS2 and HS3 rail networks).

Risk reward

Tenant profile should be conducive....

- Families are likely to predominate. These would be expected to seek out more modern fit-for-purpose stock; hence, minimising the danger of voids and the obsolescence of the assets. The developer partners are likely to deliver a good quantum of stock – from which PRS can select the most appropriate.

.....but at risk of future competition – should be robust though

- Locations may be at risk from future competing development but the Manager's expertise gives us confidence. Build costs are 100% fixed.
- PRS REIT enters into short-term (maybe an average 3-5 years) letting contracts with families so there is a re-letting exposure. There is also a maintenance risk, primarily at the point of tenants vacating. To-date, virtually all stock has been let before completion and the lettings agents have a fixed fee (although we suspect this % is fixed for some years but not indefinitely) regardless of churn.
- Political risk relates to tenancy/rent controls being proposed by the Labour party, but 1) these would likely not impact PRSR negatively given the affordability of PRSR rents and 2) it might benefit from market-shift to professional landlordism.

Regeneration in North and Midlands

- The focus is the north of England and the Midlands – offering higher net initial yields, lower historic volatility but also lower medium-term growth (close to CPI). There are higher initial yields but probably no real rent inflation; this may be considered a more sustainable profile (bearing in mind UK-wide concerns on rental expense).
- The Manager has, to date, spent £340m with Countryside, the construction partner, but we consider it is beneficial that Keepmoat will soon be delivering and we would hope for a third participant. The PRS REIT has a pipeline of specific forward contracts in place of approximately £300m (plus) of PRS assets, with a further £800m visible - happily no longer all with one developer.

Investment case

Letting record is strong and PRSR is not at risk on costs either on construction or re-letting

6% dividend yield sustainable but growth – time will tell

A strong momentum of quality developments is in place and PRSR clearly facilitates the whole development of certain regenerating sites. Quality for tenants is excellent access to amenities close by (including schools), reduced running costs and houses looking exactly as if they were owner-occupied. To date, virtually all properties are let by completion. Rental growth (it is early days) runs at c5% per year. The Manager's expertise in forward-funding and delivering private residential-led urban regeneration is well-established and robust, acting as a bridge between the public and private sectors. The PRS REIT creates assets with yields somewhat above the UK average, with the benefit of both 1) investing at the forward funding stage and 2) the geographical bias. Good initial rental yields generate a 6%+ forecast dividend yield and therefore rely less on significant rental rises: we would see these as a bonus. There is exposure to local market competition. PRSR will have the benefit – amortised over a period – of a useful cost discount v 'for sale' properties. So, the 'high' rent yield is on a value below the 100% comparable figure for an owner-occupied house.

Residential Secure Income (RESI)

Shared ownership focus

100p and £180m market cap

£180m raised – IPO date 12th July 2017

Residential Secure Income – or ReSI, ticker RESI – stated Investment Objective covers shared ownership homes, sub-market (social) rental homes, market rental homes and functional homes - with a strong emphasis on the first two categories. It sought £125m to £300m from its IPO and raised £180m. Day-to-day management, as with other REITs, is outsourced to RPs. ReSI's Prospectus refers to various other housing sub-segments. But its n main focus is on the shared ownership element. New build rates are now expanding the sector bit it remains a relatively niche activity.

Long leases but subject to the shared-owner (occupier) buying out the full equity

Shared ownership offers very secure rental cashflows and an opportunity for capital uplift once share-owner tenants eventually purchase. These are excellent assets for RPs to 'recycle', raising development funds and accelerating tenants staircasing. ReSI undertakes long leases with the RPs. We understand net initial yields are likely to be in the 3.0% to 4.0% range. Shared ownership accommodation, by definition, is part rented. The average rent starts at 2.75% of the *open market value* of the unsold equity. It is capped at a maximum of 3%. For second-hand stock in regions of recent price appreciation, yields will be below 2.75% of the open market value. The yield on the actual dealing price which, as a function of being shared ownership, may be (modestly) below its full open market value; but it should be a little over 3.0%.

Yields c3% forsShared ownership (3.5% for blended including other assets)

Rent but also debt inflates at c.RPI

Capital repayment terms on loans taken out will likely be RPI-linked. Assets are high-quality in order to support investment grade equivalent debt. Were a tenant to default, the asset reverts to the RP landlord, so a mortgage lender typically steps in to pay the rent in the extremely rare case of non-payment. Rent generally increases by RPI+0.5% per year. There is an upper income limit of £90,000 in London (£80,000 elsewhere), imposed on occupiers of such housing, so expensive parts of London are probably ruled out. This is a technically- driven but significantly growing market. The investment surplus derives from rent and market-appreciation but a part of the mix is what is referred to as 'staircasing'. This refers to the ultimate potential purchase of the portion which is rented by the occupier (who already by definition is a shared owner). ReSI is not reliant on staircasing proceeds (which is entirely at the occupier's choice) for dividend distributions; however, staircasing contributes to the total return, targeted at 8% per year.

Deployment update

The Fund Manager is owned by TradeRisks, a treasury risk advisory firm and financing arranger focused on social housing, care and other specialist residential. It has advised and, to date, has arranged funding of over £10 billion in these sectors.

Significant asset deployment but this is the most niche asset class analysed

There has been reducing supply but for a number of reasons is now reversing

On 21st September, an update was published confirming that ReSI was finalising £250m worth of shared ownership housing with three Housing Associations. At flotation, a pipeline of £263m in 1,350 homes (average price £195,000) had been identified. These portfolios are stated to be in the south of England, with completion of the purchase due shortly. A further £100m of retirement rental assets have just been purchased, in the south of England. This is 1,341 properties in 250 blocks, operated by Places for People (HA), who are responsible for rent collection and management. Rents are RPI-linked, offering lifetime tenure security.

Further analysis on asset type

Why would RPs want to sell shared ownership assets? 1) the staircasing element means these cannot be considered long-term assets; 2) it is therefore difficult for the

Only 3.5% asset yields but debt coupon on RPI-linked debt will be low

Mathematically, a rising interest rate environment could hit lower yield assets more BUT, if ReSI buys in good areas, it has good upside

RPs to secure long-term debt on these assets; 3) RPs overall debt ratios are rising, so holding assets which are less mortgageable has become relatively less attractive.

0.8% of English and Welsh households are currently in shared ownership. New delivery has averaged 12,000 per year since 2000, with a peak of 22,000 in 2009, falling to 8,000 in 2015/16. The Government has currently ring-fenced £4.1bn to support delivery of 135,000 such units: this issue is clearly moving up the political agenda. The Government White Paper (early 2017) included a 'Shared Ownership and Affordable Homes Programme 2016 to 2021', proposing the removal of restrictions on types of organisations that can hold such properties over the long-term (i.e. extending shared ownership properties beyond RPs). A significant change has thus been facilitated.

ReSI – the projected returns

ReSI targets a 3% dividend pay-out yield in the period to 30th September 2018 and 5% thereafter; it is inflation-linked. Blended asset yields of c3.5% rise with inflation. Investment grade debt is anticipated to be raised (on a fully indexed- linked basis), with the cost of such debt being low, thereby supporting the dividend yield. NAV would rise half as fast as RPI pre any yield basis 'shift'. We emphasise these should be of relatively high quality, with ubiquitous geographical spread, including covering the more expensive parts of the UK.

The Group will target an aggregate level of borrowings of 50% of gross asset value over the medium-term. This is slightly higher than some other residential REITs, but reflects the underlying strong nature of the assets and its project finance characteristic with amortisation and the long-term feature of reducing re-financing risk. Borrowings will be subject to a 67% cap. Note, the Manager will be paid a debt arrangement fee in respect of debt arranged on behalf of the Group. This fee will be the present value of 0.04%.

Risk reward

- With rising long-term interest rates, it might be considered better to own higher quality assets v those held solely for yield However, if a yield basis valuation changes on a 6% net initial yield, it will - mathematically - have a lesser impact than on a 3% yield. The micro-location of ReSI assets will be important for capital returns but dividends are linked to rental streams which remain stable.
- Shared ownership indicates lower income streams (i.e. yields) which is a factor of the stable nature of the cashflows and the very limited bad debts or arrears. The balancing factor to achieve the dividend yield is the lower debt coupon stemming from inflation linkage rather than being exposed to a large element of higher yielding 'general purpose' social housing. Social l housing may be yield lower than 4% in areas of higher residential aspirational demand.
- Inflating the capital repayment cost of debt will impact NAV but this should be largely offset by the superior relative valuation uplift on assets.
- Shared ownership tenancies tend to last several years, but not 10-20 years.

Investment case

We consider the micro-location of ReSI assets to be crucial. The Investment Manager is a wholly-owned subsidiary of TradeRisks Limited, which is at the heart of loan and finance arrangements in the social housing sector. Thus, it has strong connections with HAs and the Government; initial deployment has proceeded well. An element of asset pricing is related to market moves.

Telford Homes (TEF)

402p and £302m market cap

TEF is an operating company, not a REIT

Strategic shift – its financial implications

Telford Homes (TEF) is a well-established housebuilder with a London 'footprint' and a historic focus on buy-to-let investors, c 20% of which are currently from the Far East (as well as some owner-occupiers).

A major change – BTR forward sales are 77% of the total and up from zero two years ago

Sales mix (forward sales – the balance comprises sales to owner-occupiers)

- BTR 24% in 2015/16; 77% in 2016/17 (the figure was nil in prior years).
- Individual (i.e. buy-to-let) investors 69% in 2015/16; 20% in 2016/17.

Telford's pipeline of sold developments is higher than the sector and the ratio is growing

It is significantly changing its mix of buyers – see below – which materially impacts the business model. Market risk is lowered noticeably - at no cost to ROCE. By 2019/20, Telford should be building up to 1,400 new homes. The forward pipeline is 250% of the size of three years ago. This growth is, in part, facilitated by the expansion into BTR which has specific characteristics:

- Revenue is not dependent on the risks or costs of marketing properties for sale.
- Forward payments are received and land is typically owned by a third party.

BTR gross margins lower with lower pricing

Return on equity higher – cash generation is high

Target margins and returns

%	Individual (buy to let)	Build to Rent
Gross margin	24%	14%
Selling expenses	4%	1%
Finance cost	4%	0%
Net pre-tax margin	16%	13%
Return on equity	16%	>22%

Source: Hardman & Co estimates for ROE; Telford Homes for margins projections

Given the "very little, if any, equity" involved in BTR developments, improvements in return on capital are substantial and repeated. At this stage we estimate that the return on equity in BTR will be usefully above those from individual investment buyers. The table above shows r our current best estimate.

The CEO, in the positive trading update of 11th October, stated: "Telford Homes is operating in affordable locations across London and has an excellent reputation as a trusted partner delivering high-quality homes. We are focused on reducing risk through forward sales, limiting our need for external debt finance and delivering higher capital returns and this fits perfectly with our strategic move into the BTR sector. I expect more BTR transactions as institutional demand continues to grow alongside continuing open market sales at our well located developments." Between February 2016 and the summer of 2017, it entered into four transactions in BTR, comprising nearly 500 homes for over £230m.

Telford is working with the 'big boys'

We have pointed to the US-based, Greystar as a major player in this space, and one which will almost certainly expand its presence in the UK. Greystar has acquired two plots of land in London from the Royal Mail. Telford Homes, in a pre-instruction contract, assists Greystar with planning consents, before entering a full design and

build contract to deliver the development for a fixed price. "The terms of the contract include regular payments during the course of construction and profit paid on practical completion so Telford will invest limited equity and no debt." Telford Homes stated it "is not taking any sales or rental risk but the margin earned will account for full construction risk and therefore is in line with the Group's target margin for BTR developments. This development will represent a substantial increase in the Group's BTR portfolio alongside existing schemes with M&G Real Estate, L&Q and Folio London, part of Notting Hill Housing Group."

2016/17 Financials trends, forwards estimates

Revenue share of BTR for 2016/17 was 26%, up from 8% in the prior year

It is important to note that the reported results for 2016/17 confirmed open market gross margins of 25.4% (27.3% in 2015/16) and Build-to-Let margins of 16.0% (18.1% in 2015/16). The previous table shows the target return. The revenue share for BTR for 2016/17) was 26%, compared with 8% in 2015/16. .

Low gearing set to rise with re-investment

Balance sheet gearing of 44% in 2014/15 fell to 9% in 2015/16 and then to 7% in 2016/17. The reduction has been due to developments completing and, importantly, the upfront payments on BTR contracts on third-party land. Net debt rises through significant investment but is significantly curtailed by the trend towards BTR. Consensus for 2017/18E is, we believe, £151m, with 2018/19E at £197m. We note that the 2019/20E consensus interest cover is a healthy c9.7x.

As of March 2017, the pipeline represented near 4,200 homes with a value of £1.4 billion, over five times the multiple of historic revenue. This compares with £878m three years ago. The Group is correct to argue that it is substantially de-risked, with forward sold positions of £580m at interims (£546m).

Gross margins falling as former inflation drops out and with shift toward a higher capital-turn BTR mix

Turning to the future, consensus estimates for 2019/20 are: £442m revenues; 20.7% gross margin; £94m gross profits; £58m operating profits; and £52m at the PBT level: the EPS market projection is 55.6p.

As gross margins fall, the scope for capital turn rises. We consider the risk attaching to the business model is below that of the 'mainstream' housebuilders selling individual residential units to either owner-occupiers or individual investors.

Naturally, investors will take a view of the likely impact of potential weakness in buyer demand in London. We emphasise that this research considers the BTR shift to be of greater significance than potentially dull prospects in London for the next years. Furthermore, few products within Telford Homes are marketed at over £600,000 (the Help-to-Buy cut-off limit for owner-occupied sales).

The stock trades on a rating below the peer group of housebuilders, both on a PE basis and on a P/NAV basis.

We do not provide full forward financial estimates.

NB Interim results were posted 29th November. Figures are given for full year 2016/17 with updates to interim where stated. Forward views reflect the Interim statement.

Triple Point Social Housing (SOHO)

103p

£206m market cap

£200m raised – IPO date 8th August 2017

Long term and (effectively) government-backed income

An investment in the REIT will enable investors to gain exposure to a portfolio of social housing assets in the UK, with a particular focus (c. 80% longer-term, 100% to date) on 'supported' housing. This stock is being acquired on yields of 5.5% to 6.5% (somewhat higher than 'general needs' stock).

Covenant risk is low and so these truly are 20-year income streams

Assets owned by the REIT will be leased from Registered Providers (RPs are Housing Associations, principally) on long-term, inflation-linked fully repairing leases – and covenant is very high. Forward funding of pre-let developments may be undertaken. As with the assets in this sector, generally, underlying rental income coming in to the lessee is c 85% or more from HM Government (Housing Benefit and other payments).

A seed portfolio has been acquired. See more details, below. Each property has been recently constructed as purpose-built supported living accommodation and comprises between 16 and 18 self-contained, one-bedroom flats and semi-detached bungalows, with an on-site staff office and sleep-over facilities in addition to ancillary parking areas and communal gardens.

Some stock is converted but (increasingly) likely to be purpose-built

The five properties taken as a whole provide 82 units of accommodation (thus an average value of £218,000 per flat – a figure in line with many similar operators). We note there may be a higher level of modern stock than that of Civitas Social Housing, which has a similar tenant profile.

Deployment of funds

Decent roll-out of portfolio acquisitions but still await a forward funding purchase

Two updates issued in November confirmed that to date £48m has been deployed. Most assets are in the north of England and Midlands, on 20-25 year leases, in the supported housing segment. Leases rise at least with CPI and purchase yields are at least in line with stated criteria (circa 6.0% plus). The average cost per flatlet within the houses is averaging below the seed portfolio level.

The initial seed portfolio had been five supported housing assets, at a purchase price of £17.9m, a 6% asset Net Initial Yield. The Seed Portfolio has been independently valued at £18.5m by Jones Lang LaSalle. The vendor was Pantechnicon Capital Limited, a company within the Triple Point Group. The assets, which are located in Bloxham, Leeds, Newcastle, Rushden and Stoke, have each been leased to Inclusion Housing CIC, a Registered Provider, for an initial term of 20 years. Triple Point Social Housing is not buying expensive portfolio assets.

What to look for

We consider a strong relationship with local authority commissioners is key and SOHO appears to have this benefit

The model is expected to include significant (pre-let) forward-funding of new-build. Triple Point Social Housing has an origination strategy based on good developer relationships and more evidence (with three or more of these) would be anticipated. Triple Point Social Housing's Investment Manager's expertise lies in the social housing sector and other social sector leased assets such as solar, combined heat and power and vehicles. Local authorities tend to be important participants as instigators of investment in the sector. Their commissioners start with understanding the needs of the end users of services, so this is not procurement: it is about delivering a service - not buying a commodity. All real estate participants in this sub-sector need to appreciate this distinction, and Triple Point's history places it in a good position in this regard.

Further asset and fee analysis

25% of total fees per annum will be payable in Ordinary Shares.

The REIT targets a covered progressive dividend equal to 5% of the Issue Price once fully invested – standard for the sub-sector.

Fees payable to the Delegated Investment Manager are standard for the sector: 1.0% on NAV up to £250m; 0.9% on NAV from £250m to £500m; 0.8% on NAV from £500m to £1bn; 0.7% beyond that. There are no performance, acquisition, exit or property management fees. 25% of total fees per annum will be payable in Ordinary Shares.

Risk reward

- Predominantly 20 + year leases, all within the regulated social housing sector.
- Over the last 10 years, Triple Point Group has invested over £1bn and has built relationships with more than 150 active UK public bodies including Central and Local Government, Housing Associations and NHS Trusts. A steady rate of acquisition has been achieved, indicating a wide-spread pipeline: a good thing.
- 'Specified needs' housing is bought on yield premiums in long leases. Forward funding of developments entails construction, but not occupancy risks and should give rise to value uplifts. To date, construction partners have not been stated, but it would most likely be the case that only experienced, well-resourced partners are likely to be selected. The REIT will not be buying land 'speculatively'.
- The REIT has entered into long-term commercial contracts and the RPs take the risk of voids, costs and rental levels. Clearly – just as with other REITs investing into social housing – Triple Point is taking a calculated risk regarding the covenant (the ability of the lessee to pay the monthly commercial rental stream to Triple Point), but Housing Associations historically have been excellent risks.
- The Directors currently intend that the Group should target a level of aggregate borrowings over the medium-term equal to approximately 40% of the gross assets. This is now a standard low-risk borrowing ratio, on such, relatively, low-risk assets.

Investment case

Good connections – but look to see them widened further

Triple Point Group's connections, a strong basis for fund deployment, are illustrated by the seed- and follow-on portfolios. At this early stage of SOHO, it is important to note that Triple Point Group is a specialist investment firm founded in 2004, with over £470m of assets under management, returning approximately £130m to its investors during the last two years, in line with the applicable investment mandates. Advisors include operationally experienced personnel with regards social housing.

High yield tends to insulate against rises in cost of money

Assets acquired on these c.6% plus yields give good insulation against potential future long term rises in interest rates. Within the residential REIT sub-sector, supported housing is a common theme and so too is pre-let forward-funding: Triple Point combines the two. The size of the sub-sector (with well over £2bn rent paid annually) and the factors which we have outlined supporting demand for transactions, lead us to anticipate a good roll-out of investment funds. Occupancy in larger institutions is falling, both short and long-term, and the RPs have a constrained appetite for development of this type of long-term asset on their own books. Care providers are also, in some cases, not regarded as the most appropriate holders of such assets, so Triple Point Social Housing should see a good selection of potential purchases.

Watkin Jones (WJG)

215p and a £552m market cap

WJG is an operating company, not a REIT

The model and markets addressed

Watkin Jones is a developer, constructor and manager of UK multi-occupancy property. It has made its reputation in student accommodation and that expertise in land buying, sale of assets to institutional investors and management of the blocks, transfers directly into BTR. It possesses in-house skills others do not: planning teams, ongoing management of tenants, breadth of connections, namely for the selling-on the developments and thus recycling capital. The BTR market is currently substantially smaller than student purpose-built but is set to become much larger.

WJG targets developing c.1,500 BTR units FY18 to FY22: we see much growth beyond that. Its scope for expansion is substantial, we see its established position in sourcing land, developing and finding buyers giving it real competitive advantage in BTR.

WJG's Fresh Property Group manages over 16,000 student beds, just 535 build-to-rent (BTR) flats. Both figures are rising well, but 'BTR' growth is explosive

The end October trading update evidenced this good strategic position, albeit some profit-taking in the shares took place. WJG manages the student rooms it has handed over and currently has (its Fresh Student Living brand) 16,082 student beds across 53 schemes for the 2017/18 academic year (12,337 beds across 44 schemes a year previously). Five Nine Living manages 535 BTR flats. These provide a seamless asset management income stream so the operational gearing of the growth in both divisions is substantial. Growth should lead to margin expansion.

WJG has extensive, trusted, contacts with land vendors, tenants and end-investors in the asset. It acquires the land (often 'on risk') and provides the end-investor with good buildings, offering strong and sustainable yields. All developments are pre-sold, providing WJG with certainty, and not competing with end-investors and optimising capital turn. Its target markets are attractive.

Pre-sale – recycling capital

Financially and operationally, the same model dynamics are presented by Student purpose built accommodation (PBSA) and BTR (tenancies will be longer in the latter). This publication does not focus on the student operations. But, to put it in context, Unite Students is currently the UK's largest and most established manager and developer of PBSA, home for c.50,000 students. Rather, we assess the migration of the balance of WJG business into the BTR segment, whilst keeping up PBSA growth too, where its strength is established.

With strong expertise in land acquisition and development of these specialist sites (which, for character, often assume an element of refurbishment of re-purposed property), WJG also, at the other end of the asset cycle, has strong connections to asset buyers. Land vendors trust WJG to develop some of these more difficult but value-added sites. It is recognised as a Tier 1 Developer and Contractor, giving comfort to Institutions over delivery. It should be noted WJG is also a successful local housebuilder, with c. 160 plots, but it is turning this landbank steadily into cash.

2017

Expansion into BTR continues with great confidence, with six schemes currently targeted for delivery over the period FY19 to FY21 – on similar gross margins and returns to student accommodation. The first BTR development has been recently completed in Leeds (322 units) – on a WJG site also developed for student accommodation. One site has been secured in Sutton (132 units), two other sites have also been secured and are progressing through planning, and a further three in

negotiation (subject to planning). Market consensus of PBT, EPS and dividends of +10% next year should prove well founded on this basis. Finance costs are negligible.

PBSA as an asset class "is now seen [Watkin Jones commentary] as mature. £3.2 billion of stock was traded during 2016. £3.5bn of stock is predicted to be traded during 2017. Investment sentiment remains strong."

Risk mitigation

The pipeline gives WJG great visibility, 24 to 36 months out. There is thus time to move with market trends, locking in sales (and supply chains) early. WJG's management has strong connections with asset-investors, which currently comprise UK and North American long-term institutional asset managers.

WJG's high profile in PBSA is of significant benefit: consumers coming out of modern PBSA will recognise Five Nine Living as the next (sociable) step. Potentially up to 500,000 students pa leave the higher education sector.

5,000 beds under management are required to break even (source WJG), so now with near 17,000: 1) barriers to entry are high thus gross margins are high; 2) margins at this stage of size are now exhibiting strong operational gearing and the pipeline momentum means WJG's beds under management are guaranteed to grow, at least for three years. In fact, growth should continue for many years, with beds under management increasing via each new development (which WJG sells).

The forward sale model significantly helps to reduce the Group's cash requirements, as developments should be cash positive once they have been forward sold. Six of the 10 developments due for completion in FY18E are pre-sold and the others well-advanced in legal negotiations for sale.

Financials

c.2.5x pa turn of equity (low debt model), operating margins 14.5% and likely to be rising

Watkin Jones Group's low-risk development profit growth is set to be enhanced by the move to BTR. The Accommodation Management is effectively an 'annuity type' income and it is growing sustainably by over 20% pa. If this annuity, with this growth, is placed on 20x gross profits net of tax, its value would theoretically be well over £50m or near 10% of the Group's market capitalisation. Whilst the value in the Group resides within the overall package from land find to sale and management, this cash-generative 'annuity' growth is an important part of the financial de-risking.

1H17 21.7% gross margins (up from 17.9% and gross profits rose 24%

63% gross margins in fast-growing 'annuity style' tenant management business

WJG in 1H17 turned its average equity of £108m 1.23x which is 2.46x annualised turn. Operating margins were 14.5% 1H17, so as use of debt was near zero, ROCE = ROE = 36% before tax. WJG's total shareholder return over the past year is well above the housebuilders and stands at a price to book of slightly over twice that of the housebuilding sector. 1H17, WJG achieved a 21.7% gross margin (17.9% 1H16). Gross profits rose by 23.8%. With the fairly substantial fixed cost element of any residential management business, and with units managed rising with each new development, margins should have upward bias. Historic year, that division comprised only 3.2% group gross profits, at 63% margins. But 1H17 management division revenue and profits were slightly ahead of FY16. Growth prospects are substantial. Number of beds managed, CAGR as stated by WJG to FY20, is 18%+. 6.7p EPS 1H17, was up 29%.

The data above are for 1H17, but there is an element of H2 bias. FY16 ROE stood at 43% (adjusted, based on £37.9m operating profits ex exceptional IPO costs and estimated average equity assets employed base on the £88.8m at the end of 1H16). It is worth highlighting that the FY16 results were achieved with some capital employed in BTR but profits booked being minimal.

Shareholdings

Largest shareholders

Civitas Social Housing	Shareholding %	Change %
Investec Wealth & Investment	16.26	+0.34
Killik Asset Management	6.07	+6.07
East Riding Pension	5.35	-0.37
EFG Private Bank	5.14	+5.14
Tilney BestInvest	5.12	+0.28
Fidelity International	4.69	+0.09
Close Brothers Asset Management	4.39	+3.96
J. M. Finn	4.33	+3.29

PRS REIT	Shareholding %	Change %
Aviva	11.56	+11.56
Homes Communities Agency (HM Government)	9.99	0.00
AXA Investment Mgt	7.64	+7.64
Janus Henderson	6.04	+6.04
BMO Global Asset Mgt	5.10	+5.10
West Yorkshire Pension Fund	3.50	+3.50
CG Asset Mgt	2.39	-0.20
Blackrock Investment Mgt	1.74	+1.74

Residential Secure Income	Shareholding %	Change %
Schroder Investment Mgt	14.88	+14.88
Close Brothers Asset Mgt	9.44	+9.44
CG Asset Mgt	8.32	+8.32
Premier Asset Mgt	4.02	+4.02
West Yorkshire Pension Fund	3.88	+3.88
South Yorkshire Pensions Authority	2.77	+2.77
Blackrock Investment Mgt	2.07	+2.07
Schroders Private Bank	1.68	+1.68

Triple Point Social Housing REIT	Shareholding %	Change %
Investec Wealth & Investment	17.00	+17.00
CCLA Investment Mgt	9.50	+9.50
East Riding Pension Fund	9.50	+9.50
Schroder Investment Mgt	7.40	+7.40
Brewin Dolphin Ltd	5.03	+5.03
Smith & Williamson Investment Mgt	5.00	+5.00
Close Brothers Asset Mgt	4.99	-0.79
Places for People Living Ltd	2.50	+2.50

Source: Thompson Reuters 20/11/2017

'CHANGE' is defined as the % holding movement at last change notified. In most cases, for the 2017 flotations, the last change was the initial IPO holding

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