Reasons to be cheerful
Uncovering value at the top of the real estate cycle
Part 3: Social supported housing in the UK

With the majority of commercial real estate sectors at their peak globally, especially in gateway cities, Schroders Real Estate has been hunting for specific segments which are not just attractive today but, in the context of our ‘mega-theme’ framework, have structural support reasons which should mean they will sustain their value in the future and offer upside potential.

Social supported housing in the UK is a sector that has these characteristics and represents a compelling investment opportunity for investors seeking:

- Returns uncorrelated with economic and property cycles
- A favourable structural supply and demand dynamic
- A c.6.5% unlevered income yield at the asset level
- Government-backed, 20 year+, triple-net leases explicitly linked to inflation
- Strong social impact investment credentials

Introduction

Total returns in the UK and European commercial real estate markets are forecast to weaken over the next five years compared to the last five. Prime yields are at an all-time low across many sectors (figure 1) and rental growth is starting to slow. This is concerning investors (figure 2) and pushing them to consider investment opportunities in alternative, non-mainstream sectors that offer comparatively attractive income and/or total returns and are driven by long-term structural changes which are independent of the economic cycle. These sectors should be relatively defensive and offer portfolio diversification.

Some segments such as student accommodation and build-to-rent residential have already seen significant yield compression as institutional investors have entered those markets. However, there are still several segments which have yet to gain the attention of professional investors and which offer not just attractive risk-adjusted returns today, but may also benefit from future yield compression as they become mainstream.

Figure 1: Net initial yields by sector in the UK
Uncovering value at the top of the real estate cycle
Part 3: Social Supported Housing in the UK

What is Social Supported Housing (‘SSH’) in the UK?

- Public sector-funded accommodation for adults who require mid-acuity, life-long care and support such as people with learning disabilities, autism and mental illness, providing them with independent living in the community instead of a registered care home or in-patient facility.
- SSH is a distinct category of social housing and is separate from ‘registered care homes’, sheltered housing for the elderly, hostels for homeless people or affordable housing for those on low-incomes
- While traditionally housing such individuals in an institutional setting like an acute hospital at significant cost and in an environment that is potentially detrimental to their well-being, the public sector is seeking financial support from the private sector to create new, purpose-built or re-purposed accommodation in the community. This will not only lower costs but provide a much improved living environment for residents where they can live independently in the community, while receiving the support they need
- SSH is widely regarded as the most appropriate form of accommodation for people with specific-learning disabilities. Residents rarely move once they are in an SSH scheme, even if there may be a perceived immediate cost benefit, due to the fact that a change in physical environment can result in much higher care costs associated with re-assimilation
- The housing element is typically 15% of the total annual cost to the public sector of the residents (c.85% being the care element) and is contracted separately from the care provision so that the resident can stay in his/her current accommodation even if the care provider needs to be changed. Registered providers such as housing associations, local authorities and other not-for-profit organisations enter a 20-30 year, NNN/FRI, pre-lease on the property indexed with inflation (see diagram on the following page). The registered provider then reclaims each resident's rent from the local authority, who in turn receive funding from central government via the Housing Benefit system.

Schroders’ six mega-themes

In developing a forward-looking methodology for assessing the future requirements of real estate occupiers globally in terms of where people work, live and play, Schroders identified five mega-themes that have underpinned our investment philosophy for several years: rapid urbanisation; demographics; technological revolution; resource and infrastructure; and the shift of economic power from West to East. We are now seeing the emergence of a sixth mega theme – positive impact investing – and believe that moving forward, all our investments should have a positive social impact for occupiers, communities and investors.

By interpreting the interplay between the mega-themes we have sought to uncover attractive opportunities in today’s commercial real estate market where sustainable income and/or capital growth might be derived in future. In the case of social supported housing in the UK, the mega-themes that support the investment case are:

- Technology improving survival rates at birth and extending life expectancy for the residents of these properties which impacts demographics and enlarges the population and hence demand for these types of properties
- Changing social attitudes and the desire to do more to integrate the residents into society and improve their quality of life

What keeps you up at night?

<table>
<thead>
<tr>
<th>Issue</th>
<th>%</th>
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<tbody>
<tr>
<td>We are nearing another cyclical market high point</td>
<td>62</td>
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<td>Too much money is flooding into real estate, driving down returns while adding risk</td>
<td>59</td>
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<tr>
<td>Too much money is chasing too few quality managers/funds</td>
<td>27</td>
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The investment case for social supported housing in the UK

1. Increasing population requiring SSH

We expect the demand for SSH for adults with life-long learning disabilities, autism and mental illness to grow strongly over the next decade. Advances in technology are improving survival rates at birth and similarly increasing life expectancy. Projections suggest that the number of people with a learning disability (and who are eligible for public sector support) will grow by between 55,000–70,000 over the twelve years to 2030, or by between 1.25–1.75% p.a. (Figure 3), compared with 0.4% and 0.7% p.a. for the UK population as a whole.

Figure 3: Cumulative increase in population requiring SSH

Furthermore, the UK public sector has an explicit target to close the health gap between people with a learning disability and the rest of the population.\(^2\),\(^3\).

Source: Learning Disabilities Observatory. 2011

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\(^3\) Department of Health & Social Care. 2018.
Reliance on informal care

38% of people with a learning disability live with family, or friends (figure 4), but these arrangements can break down as relatives’ own circumstances change and they find that they can no longer provide care\(^4\). For example, it is estimated that there are 29,000 people with a learning disability who are living with a parent who is 70, or older\(^5\). A further quarter of people with learning disabilities live in ordinary, unsupported accommodation.

Given the choice, most adults with a learning disability would choose to live in SSH, because of the independence, privacy and security of tenure that it offers. They, or their family, also like the opportunity to take control of their care. Adults who move into SSH often gain in confidence and enjoy a better quality of life and greater wellbeing\(^6\).

**Figure 4: Where adults with a learning disability live**

![Figure 4: Where adults with a learning disability live](image)

*Source: Housing for People with a Learning Disability. Mencap. 2016*

### 2. Small existing SSH stock

Despite a long series of government policies promoting care in the community, there is a serious shortage of SSH. The number of public sector beds for people with a learning disability or mental illness has fallen by 80% over the last 30 years (figure 5).

The charity Mencap estimates that there are 22,000–30,000 SSH units in England. However, that is clearly insufficient given that there are currently 250,000–300,000 adults with a moderate or severe learning disability\(^7,\(^8\).

![Figure 5: NHS Hospital Beds](image)

*Source: NHS Hospital Beds Numbers. The Kings Fund 2017.*

### 3. Significant cost benefits

When looking at the overall cost of an individual requiring care and housing, a person living in SSH requires state funding of circa £1,569 per person per week, compared with £1,760 per week for a person in a registered care home and £3,500 per week for an in-patient facility (figure 6). The difference between SSH and a registered care home is mainly due to lower care costs, rather than housing costs. Thus, not only does SSH have a positive social impact, but it is also more cost effective for the UK Government.

**Figure 6: Average weekly cost**

![Figure 6: Average weekly cost](image)

*Source: Funding supported housing for all. Mencap. 2018*

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\(^4\) Housing for People with a Learning Disability. Mencap 2016.

\(^5\) Learning disability statistics: support. www.mentalhealth.org.uk

\(^6\) Funding supported housing for all. Mencap. 2018.


4. **Statutory obligation to provide SSH**

The UK Care Act 2014 gave local authorities legal responsibility to provide vulnerable adults with long term, safe accommodation. The department of health also promotes a focus on providing support services that favour independent living over registered care homes or in-patient facilities.

Moreover, councils have a statutory duty to provide affordable housing to those who qualify, and retain a responsibility to provide accommodation for vulnerable individuals.

The need for a significant number of additional SSH developments is therefore clear, but deep cuts in government grants mean that housing associations lack the requisite funding and are unable to match demand. As a result, there is an opportunity for private investment to meet the latent and growing demand.

While the annual budget for SSH rent and housing benefit is large in absolute terms at £1.4bn, it is a small proportion of the government’s total spending on housing benefit (6%) and an even smaller fraction (0.6%) of the total UK welfare budget (figure 7).

5. **Positive social impact**

SSH residents are some of the most vulnerable people in society. Their conditions are generally life-long, complex and irreversible. As a result there is cross-party support amongst all the major political parties which means that the SSH budget is one of the least likely to be challenged⁹.

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**Figure 7: Breakdown of the UK welfare budget of £246bn¹**


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⁹ Paying for supported housing. House of Commons Library. 2018.
Creating, or repurposing existing housing stock specifically for the SSH sector is probably one of the most meaningful ways in which investors can make a positive social impact investment for the following reasons:

– Transferring residents to a modern, purpose-built setting in the community can have a tremendous positive impact on their health and mental well-being. The improved environment offers them a much better quality of life and frequently results in reduced and/or less-intensive care requirements\(^\text{10}\)

– The resulting savings can be redeployed to increase the support to other adults with more severe learning disabilities or those who may be living with elderly parents, or in other arrangements which are less than ideal

– Much needed in-patient capacity is freed up in institutional health facilities

6. High-quality, secured, long-term, inflation-linked returns

The specific opportunity for real asset investors is to forward-fund the development of new and or repurposed/refurbished, small, community-based blocks of SSH units. These typically comprise 3–20 units at a development cost of £0.3–5.0m. There is no planning consent risk (as this will already have been obtained before any capital is committed) and there is no occupier risk because the units will all have been pre-let under triple net/FRI leases to registered providers.

The lease agreements between the investor/developer and the housing association average 25 years in length and the rental payments are inflation-linked.

The distributable unleveraged cash-on-cash yield to investors (before any manager-related fees, etc.) once the assets are completed and stabilised is c.6%. It is believed that the total unleveraged return to investors (again, before any manager-related fees), without assuming any yield compression due to the institutionalisation of the sector and/or the aggregation premium of a meaningful portfolio, is c.10%.

Finally, this sector is arguably uncorrelated with economic cycles or even the broader property market. In particular, it is particularly suited to long term investors seeking to diversify their real asset portfolios and benefit from defensive, inflation-linked income, while maintaining strong covenant quality, creating a strong yield-on-cost, avoiding capital redeployment risk and obtaining some exposure to potential yield compression.

Understanding and accessing the social supported housing sector

Investing in specialist sectors requires specialist analysis. Where to look, and how to size up the risks specific to that area poses a challenge that not all investors are equipped to face. SSH is a very granular and very fragmented sector which creates significant barriers to entry for new investors, so it will be important to leverage the skills of an experienced partner.

We believe that the returns on SSH should be less volatile than the returns on commercial real estate and private rented housing, given the stability of demand, the shortage of accommodation and the low turnover of residents and high continuity of income. But the sector is not without risk.

A future government could extend rent controls on general need social housing to SSH, although we think this is unlikely. Liquidity in this niche area of the market is also a factor. However, we believe that this is reflected in the relatively high yield that SSH offers. Furthermore, it is possible that the sector could enjoy an uplift once it becomes more established and more commonly traded. Counterparty and reputational risk are also factors, but again these are concerns that we believe are manageable with rigorous analysis and due diligence.

\(^{10}\) Funding supported housing for all. Mencap. 2018.
Summary

- Yields across most global commercial real estate markets and sectors are at historic lows and future returns are consequently expected to be lower than the past few years. Despite this, we believe there are still reasons to be cheerful for investors willing to devote the time to consider the less well-trodden path as there are still pockets of value to be uncovered which will also add diversity to portfolios.

- Schroders’ mega-theme framework for considering the drivers of future occupational demand has identified SSH in the UK as a sector with the right characteristics to benefit from these themes. In particular, favourable demographics driven by technological advances in medicine and a very positive social impact profile which will actually enhance returns.

- The long-term, high-quality, inflation-like, asset-backed, stable nature of the cashflows make the economic case highly compelling, especially when they are not correlated with the economic or property cycles and the favourable demand and supply dynamic is so clear.

- SSH is not an easy market to access, especially in scale given the small asset sizes involved. However, in such a fragmented and immature market the opportunity exists to build a meaningful portfolio with a partner who is sufficiently experienced in sourcing, developing and managing these specific assets while properly mitigating the risks.

Schroder Real Estate

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Schroders has managed real estate since 1971 and is one of Europe’s largest managers of real estate. Our investment range allows our clients to access real estate through open ended funds, listed REITs, specialist funds, joint ventures, separate accounts and global real estate securities. As at 31 December 2018, Schroder Real Estate manages £15.6bn (~US$20bn) of real estate on behalf of a wide range of institutions.

Our philosophy

Our philosophy is centred on consistent principles, to invest in strong fundamentals and to actively manage real estate portfolios. Our research-led approach identifies themes and trends informing our strategies to invest in locations and assets best suited to long-term real estate investment. As a result, our portfolios are located in ‘Winning Cities’ and regions best suited to benefit from these trends. We are an active manager of real estate, each asset has an individual business plan and is actively managed throughout its life to generate the optimum return for our investors.

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