PROVIDING CARE TO THE HOMELESS

'CARE THOUGHTS' MARCH 2023

1. Introduction

The investment proposition at Home REIT resembled that pioneered by social housing REITs like Civitas and Triple Point, but applied to a highly vulnerable and more transitory group of tenants - the homeless, prison leavers and victims of domestic violence.

The idea was that investors could generate stable, long-term, index-linked income in a socially responsible manner through long-term (20-30 year), inflation-linked lease agreements. These were entered into with small Housing Associations and Community Interest Companies (CICs) which lacked the financial resources to acquire the properties but could lease them from Home REIT instead.

The leases were to be paid for by renting the properties to tenants under exempt rents funded through Housing Benefit. As a result, the income Home REIT received from its intermediaries appeared to ultimately be government-backed while generated in a socially responsible manner, a strong attraction for impact investors.

The business model enabled Home REIT to raise significant equity investment from institutional investors, with over £850m provided from its 2020 IPO and two subsequent equity issues.

Date	**Amount Raised**
October 2020 (IPO)	£241m
September 2021	£350m
May 2022	£263m

Source: Home REIT company filings

Unfortunately performance failed to match expectations. Many of the Housing Associations and CICs failed to fully let the properties for a variety of reasons, including suitability and the state of repair, while there have been significant delays in receiving the exempt rents from government through Local Authorities.

This has led some of Home REIT’s counterparties to go into liquidation while others have withheld lease payments either because they lack the resources to pay them or because of disputes over the state of the accommodation.

It has left Home REIT fighting to stabilise the business against the background of significant:

a. Counterparty risk
    - From small organisations struggling to generate sufficient income:
        - To maintain the properties in an appropriate state,
        - Provide the requisite services, and
        - Rent them to tenants that qualify for exempt rents.

b. Operating risk
    - Involving the state of the properties acquired and leased out, and
    - The need to maintain them in an appropriate state for use.

c. Valuation risk
    - The danger property valuations fail to match the cost of acquisition/conversion, and
    - Difficulties on resale at vacant possession values once occupied.

d. Political Risk
    - Intervention from government to stabilise and regulate the market, and
    - Impact on Home REIT's counterparties of the Supported Housing (Regulatory Oversight) Bill currently going through Parliament.

e. Reputational risk
    - From providing street properties in difficult locations to charities
    - That fail to meet their needs or qualify for Local Authority support.

Many of Home REIT's counterparties were attracted by the long-term lease agreements which initially allowed them to generate healthy surpluses if fully relet to tenants on exempt rents. Unfortunately in a period of high inflation, rising lease payments and spiralling maintenance and repair costs have put them in a difficult position. This has been aggravated by problems over the suitability of some of the accommodation and delays in reclaiming exempt rents. It led to a significant deterioration in rent collection over the course of 2022:

a. Defaults on lease payments and
b. Withholding of rent following disputes over responsibility for maintenance costs.

With accelerating scrutiny from institutional investors over its business model, the share price of Home REIT fell sharply from the level at the May 2022 equity issue, with shares eventually suspended from trading as its auditors failed to deliver the audited accounts on time.

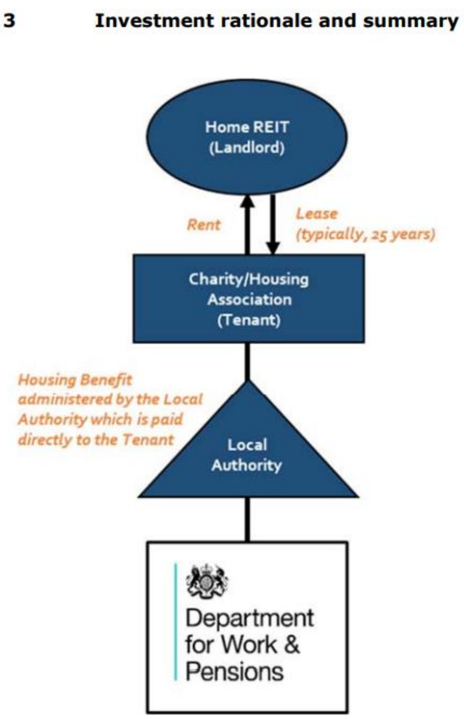
2. The challenges of the model

Counterparty Risk

At the time of IPO in 2020, considerable focus was placed on the ability to access government-backed income from exempt rents.

"*Government funding for each individual occupant generally represents the full cost of care and housing benefit for that person and is paid from the Department of Work and Pensions to the relevant local authority, which then passes funds directly to the Company's tenants (being the housing associations, registered charities, community interest companies and other regulated organisations to whom the properties are let).*"

Unfortunately less emphasis was placed on the complex process involved in accessing this which involved a number of counterparties, as can be seen from the table below:



Source: Prospectus dated 22 September 2020

In particular it depended on three things

- The ability of the Housing Associations and CICs to meet the lease payments,
- The capacity of the counterparties to make gainful use of the properties, and
- Their ability to extract exempt rents from Local Authorities for the tenants.

Despite a £350m pipeline[1], investors were provided with limited information about these potential counterparties other than the fact that the fund manager would partner with '*Experienced tenant[s] with robust financials and a proven operating track record*'[2].

While this may originally have been the case, a significant proportion of Home REIT's rent roll was contracted with CICs established in the last five years, on whom there is little financial information available for investors to scrutinise.

Many are not required to publish audited accounts under the exemption for small companies and are either unregulated or regulated only by the Charity Commission, meaning their financial viability is also not assessed by regulators.

5 Largest Counterparties by Rent Exposure[3]	Rent Exposure	Incorporation Date	Regulated HA	Report Annual Audited Financial Statements
Big Help Project	10.5%	13 March 1997	No	No
Lotus Sanctuary CIC	9.9%	25 August 2018	No	No and in liquidation
Supportive Homes CIC	8.6%	19 March 2021	No	No
Gen Liv UK CIC	8.4%	4 Dec 2020	No	No and in liquidation
Redemption Project CIC	8.0%	16 Nov 2020	No	No
Total	**45.4%**			

[1] See https://quoteddata.com/wp-content/uploads/2020/09/200922-prospectus.pdf, p53
[2] See https://quoteddata.com/wp-content/uploads/2020/09/200922-prospectus.pdf, p51
[3] See https://www.homereituk.com/wp-content/uploads/2022/09/home-reit-presentation-updated-september-22.pdf, p7

There is then a further complication.

Where a Housing Association provides exempt accommodation, the Housing Benefit is fully funded by the DwP. This is done through the relevant Local Authority which will administer the Housing Benefit and pay it directly to the tenant, reclaiming the full amount from the DwP.

However, where the accommodation is provided by a non-registered provider (like many of the CICs Home REIT leases to), the Local Authority is only eligible to reclaim 60% of the rent in excess of the Local Housing Allowance (LHA). As an illustration, if the exempt rent is £100 and the LHA is £80, the Local Authority is only reimbursed for £92 where accommodation is provided by a non-registered provider, leaving it to meet the shortfall from its own budget.

This means the ability of Home REIT's counterparties to claim exempt rents not only depends on wider public funding but individual Local Authority budgets - a far more challenging source of support.

It has led to comments by a number of Home REIT's counterparties about the difficulties in receiving sign off on exempt rents from Local Authorities. For example Lotus Sanctuary CIC (now in liquidation) reported that it was owed £2.7m from "*multiple local authorities across the UK due to the time it is taking councils to review and accept exempt accommodation applications*"[4].

It has led to a situation where a majority of Home REIT's counterparties have either been unable or unwilling to cover their rent – with an announcement from Home REIT that in the three months to November 2022 the company collected just 23% of contracted rent.

This followed on closely from a successful £263m equity issue in May 2022 suggesting a lack of detailed information on how the counterparties may actually have been performing.

Structure of the Leases

The structure of the leases has also caused dispute with individual tenants.

The leases are for 20-30 years, inflation-linked and fully repairing and insuring (FRI), meaning they impose considerable obligations on the counterparties, many of which are thinly capitalised entities that cannot support any significant mismatch between revenue and costs.

This mismatch has already led to the downgrading of a number of Housing Association clients of Civitas and Triple Point to non-compliant by the Regulator of Social Housing – until such time as governance and financial viability has been strengthened.

The FRI obligations under the leases, which leave the housing providers to bear the full cost of maintenance and repairs, have led to disputes about the condition of the properties, another reason for rents being withheld. For example, Big Help Project and its sister charities withheld £6m in rent in the period March-August 2022 in protest at the state of housing provided to it by Home REIT.[5]

3. A Lack of Practical Experience in Care and Social Housing

The provision of transitional supported housing is complicated by the fact that the care or support provision is often separated from the provision of the housing itself.

[4] See https://www.cityam.com/home-reits-top-tenant-looking-to-offload-leases-as-cash-troubles-continue/.
[5] See https://www.cityam.com/home-reit-faces-legal-threat-from-biggest-tenant-over-5-5m-rent-relief-deal/

This highlights one of the attractions of the model for investors – namely the ability to distance themselves from any operating risk inherent in providing care and support for vulnerable tenants.

The ability to charge exempt rents is however tied up with the need to deliver the care, so that without close oversight there is a danger that revenues fail because of a default by the care provider.

Some of the thinly capitalised CICs which were leasing assets from Home REIT seem to be care providers, with limited experience in the challenges of selecting and managing the property. By taking on the leases they appear to have moved into an area of activity that involves considerable financial overheads without the necessary expertise to manage them.

4. Lessons Learned

It is easy to use retrospect to highlight the failings that have arisen from the business model at Home REIT, but this does not recognise the real contribution to society that could be made by providing transitional supported housing in an appropriate and sensitive manner.

The service breaks down between the supply and maintenance of appropriate housing and the delivery of the care within it. It is impacted by the relatively high turnover of tenants in transitional accommodation – each one of which will need to qualify for exempt rents, a time consuming process, particularly if it leaves the Local Authority out of pocket where unregulated providers are involved.

It, therefore, requires a lender – because that is what effectively Home REIT is – sensitive to the realities of the accommodation which needs to be provided, that can work pro-actively with the users and the care providers to allow them to refurbish or dispose of properties no longer fit for purpose.

This suggests a model that starts with three parties is more appropriate:

- An asset owner with the knowledge and skill to identify and maintain the properties in an appropriate manner – ideally as a Regulated Provider,
- A debt fund willing to lend a high percentage of asset value on medium term funding, and
- A charity or for-profit operator willing to work with the property owner to provide the care services required.

Providing accommodation, especially for the homeless, is a skilled, labour intensive activity that depends on good quality relationships with the Local Authorities who ultimately pay for the accommodation.

Many small providers have good regional relationships with Local Authorities and offer high quality care and support. Unfortunately they lack the balance sheets to purchase the properties or support the inflation-linked leasing contracts provided through Home REIT.

This suggests there is a strong case for institutional investors to move directly into the provision of accommodation which can then be used by these small providers under flexible agreements, including provisions for future disposal of the properties if they are no longer ideally suited for purpose.

It is a model similar to that developed in the charity sector by Golden Lane, built on an initial loan from Mencap and subsequently supported by banks and retail/institutional investors.

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