FUNDING CARE HOMES AND SUPPORTED HOUSING

THE TRAGEDY OF HOME REIT

'CARE THOUGHTS' OCTOBER 2023

1. Introduction

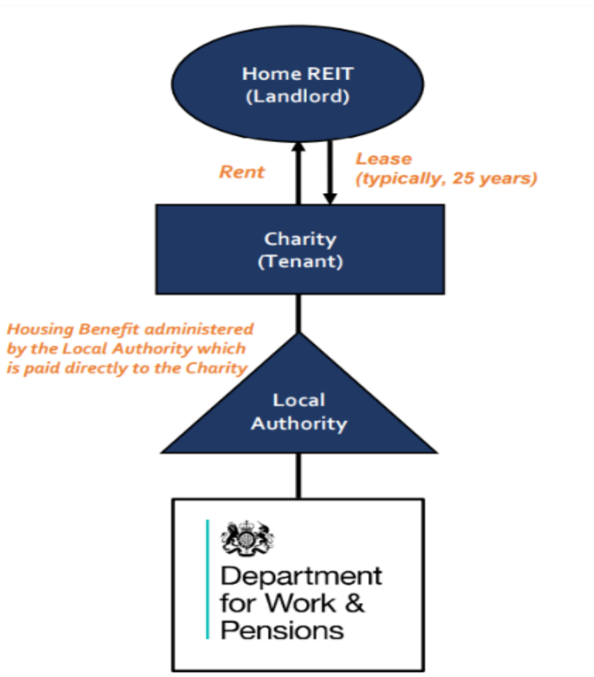
On 20th October 2020, Home REIT completed a successful IPO raising £240m for investment in short stay supported housing. It was followed over the next 1 3/4 years by two further equity issues for about £600m, together with £250m in loans made through two 12 and 15-year private placements.

The business offered "tailored cost-effective housing supply" by providing long-term index-linked leases to tenants (social enterprises and charities) and through them Local Authorities; that generated "considerable savings" on meeting their obligations to the homeless, "whilst also providing better quality housing and long-term security of tenure". [1]

It attracted widespread demand from both retail wealth managers and institutional investors[2]. Many of these were keen to find opportunities to invest in organisations delivering social impact while earning stable and predictable returns; hence the attractions of a business focused on short-stay supported housing, generating significant index-linked earnings tied to government income streams.

In the period to July 2022, a total of just under £1.1bn was raised which was used to purchase 2,308 properties spread across the UK. These were let under long-term inflation-linked leases to 28 Charities and Community Interest Companies ("CICs")[3] to provide accommodation for a wide range of vulnerable people in need of support and short-stay accommodation.

The diagram below is taken from Home REIT's investor presentations under the title: *"sustainable rents underpinned by government funding"*



The quality of the social impact delivered was further highlighted by Home REIT in September 2021 in a report it commissioned from The Good Economy, a firm specializing in assessing social impact and ESG outcomes. It stated:

"Home REIT is helping to improve the lives of those who are homeless or at risk of homelessness. Findings to date suggest that residents are very satisfied with the quality of accommodation and support from the housing partners is helpful and valued."

The report placed particular emphasis on the "additionality" offered by Home REIT by bringing homes into use as Social Housing for the first time. The report was carried out during COVID-19, so the authors were unable to visit the properties to verify some claims.

Unfortunately, Home REIT failed to highlight the challenges of accessing Housing Benefit (HB) from the DWP via Local Authorities. This can be bureaucratic and time-consuming, particularly for CICs who are not RPs.

- Typically, local authorities agree to relatively short-term contracts which sit uncomfortably with the 25-year contacts between the CICs and Home REIT;
- Local Authorities conduct inspections to ensure properties are suitable. This can result in significant delays before rent flows to the CICs.

In addition, some tenants claimed property renovations were not carried out as promised so were not suitable for the tenants; meaning they failed to qualify as Exempt Accommodation.

This situation was made worse by the financial condition of the lessees. Many were thinly capitalized with little or no track record or were encouraged to expand their operations rapidly to take advantage of the opportunity provided by Home REIT. Some also had connections or directors in common with the developers or owners of the properties Home REIT was buying and leasing back to the CIC, calling into question the independence of appraisal and judgment when assets were acquired.

It meant many lessees lacked the scale or experience to address the practical challenges involved in leasing properties for short-stay supported housing and were unlikely to survive any significant shortfall in rent collection.

Initial rent-free periods on some of the leases as properties were brought up to standard obscured the problem. However, against the background of sharply rising inflation and increasing costs of renovation and maintenance in late 2022/early 2023, the lessees began to exhibit distress with a sharp fall in rent collections, disputes over the quality of the properties and a rise in insolvencies.

Following a detailed report by short sellers Viceroy Research Group in November 2022 suggesting shortfalls in the performance of the business, Home REIT delayed the publication of its accounts. The shares had already fallen sharply, and trading was suspended in January 2023 following the failure to publish the accounts within the agreed timetable.

Home REIT share performance 2021 -2023

Source: Bloomberg

After unsuccessfully seeking buyers for the portfolio, the managers of the fund were replaced by a new team in May 2023. At this stage, only 3% of the rentals were being collected. The company appointed new property valuers to review the portfolio and mapped out a strategy designed to stabilise the business and set it on the road to survival over the following two to three years.

Part of this involved transferring leases from counterparties in liquidation (currently 21% of the rent roll[4] with more expected) or to new lessees at reduced rental levels, repurposing some properties in the short term and disposing of properties not considered suitable for the business.

To date, 177 properties have been sold at prices of between 32% and 39% of the original purchase price. If this was repeated across the whole portfolio it could wipe out the majority of the equity once the debt was repaid.

2. The problem with the business model

Viceroy Research Group's report (available on their website) clearly sets out a number of the issues that arise from the business model Home REIT adopted. In particular, they highlight that incentives for investors and management are poorly aligned to the provision of high-quality social housing delivered in a socially sensitive manner.

To these, we add a number of our own observations.

a. A publicly listed equity owner

Raising equity through a public listing is an expensive process in terms of both the fees and expenses of making an initial public offering, fees for external management and the ongoing costs of fulfilling the obligations of a public listed company in relation to transparency, oversight and governance.

It may not, therefore, represent the most cost-effective or efficient way of funding provision even if it attracts interest from retail and institutional investors keen to support social enterprises.

b. Short-term focus on performance and allocation of funds

Publicly listed equity requires management to focus on short-term performance to support the share price as well as develop a longer-term strategy for the business. Failure to do this may lead to pressures from investors and make the business vulnerable to unwanted takeover approaches.

This requirement may not be appropriately aligned to the longer-term needs of a business focused on housing vulnerable tenants. It also encourages accounting treatment and business strategies that may flatter the value of the assets or revenues generated over the short term.

This was clearly an issue with Home REIT.

c. The injection of funds into the business.

With all new equity fully paid on issue there is pressure to put cash to work as quickly as possible (“ramp up”). The REIT needs cash to be available to build its portfolio but uninvested cash during this development phase will earn a lower return, depressing earnings.

Without careful planning, this will sit uncomfortably with a strategy to maximise returns while expanding the provision of appropriate accommodation over time and could encourage some unsatisfactory shortcuts.

d. Management incentives on performance

Home REIT’s Investment Adviser received management fees with a performance element related to Net Asset Value (NAV). The faster the business grew and the higher the asset valuations, the bigger the management fee.

As there were no clawback provisions on the fee in the event of future underperformance, an incentive was created to expand the business as quickly as possible by raising new equity and taking the most optimistic view of property valuations without concern for the long-term prospects for the business.

e. Asset valuation

This walks into the confusing world of property valuations. While these were carried out by a large and well-respected firm of valuers, rather than being tenanted open market valuations or observable transactions, it seems they were largely based on a discounted cash flow basis (DCF), discounting the cashflows of the inflation-linked leases.

In many cases, this appears to have generated valuations significantly in excess of the open market prices for comparable properties and allowed Home REIT to book profits enhanced by significant valuation gains.

The valuations did not appear to take into account the thinly capitalized nature of most of the leasing counterparties nor the fact that their arrangements with Local Authorities were clearly for much shorter periods.

f. Straight line revenue

Finally, there is the issue of adjustment for straight line revenue.

This allowed Home REIT to account in any year for the average rent it receives over the life of the lease even when it is higher than the actual rent due for the period. While the "accretion effect of straight lining rent" is broken down as a figure in the accounts it still inflates earnings and the valuation of the properties.

5. Investment Property

	As at 31 August 2021 £'000
Property acquisitions in the period	8,980
Accretion effect of straight-lining rent	48
Change in fair value of investment property	437
Fair value at 31 August 2021	**9,465**

7. Investment property

	Freehold Investment Property £'000
Half year ended 28 February 2022	
Balance at 1 September 2021	327,860
Property acquisitions in the period	358,034
Accretion effect of straight-lining rent	1,518
Change in fair value of investment property	25,961
Balance at 28 February 2022	**713,373**

Source: Viceroy Research

3. The road ahead

The failure of Home REIT has seriously damaged the ability to raise equity from retail investors, wealth managers and institutions in the public market for all forms of supported housing. It serves as a warning to those attracted by the concept of locking into high-quality government sourced income flows as these are rarely risk-free, involves scrutiny over the quality of the product delivered and often depends ultimately on shorter dated contracts.

If this is the story of Home REIT, it is also the story of Four Seasons and Southern Cross, where expectations of predictable inflation-linked revenue connected to Local Authority residents turned out to be ill-founded. In both cases, the failure of the model left investors with substantial losses which have seriously undermined the availability of capital at a reasonable price.

The performance of these borrowers also highlights the dangers of applying the analytics and attitudes of commercial property investors to businesses operating specialist housing and care. It involves using properties over the medium or long term to house vulnerable people, where assets cannot be transferred as easily as with commercial properties and the revenue streams (or residents) often require sensitive, and costly, management.

At the same time, the strong commitment from a range of investors to support businesses delivering social impact should not be underestimated – particularly in areas of vulnerability, where demand for accommodation significantly exceeds supply.

This is particularly the case with Pension Funds and Charitable Trust Funds, though it is now likely to extend far further than this. These investors do not need a public listing but place considerable importance on generating sustainable long-term income in a socially responsible manner.

4. The potential attractions of the credit model

Local Authorities are under a statutory obligation to provide short-stay accommodation for a wide range of people in need. This ranges from the homeless through people recovering from drug or alcohol abuse to those escaping from domestic abuse.

There has been a serious lack of public investment in developing the appropriate facilities so the majority are placed at considerable cost in short-term private lets or hotels. Many of these properties are unsuitable or of a relatively poor quality while the rents are generally substantially higher than would be available from longer-term contracts with socially responsible owners.

While it appears to offer a natural opportunity for Housing Associations, it involves relatively short-term contracts, requires intensive management and is often connected to the provision of care. Like all Specialist Supported Housing, it generally comes with inadequate capital support so a majority of the investment in the assets has to come from internally generated resources.

This makes it unattractive from the perspective of the Rating Agencies – a factor that has also influenced the approach of individual housing associations.

Effective action is also restricted by the decentralised process of decision making. This depends on individual Local Authorities – of which there are 317 in the UK. Some of these have embarked on significant local initiatives like Newham with Local Space or Bromley with One Bromley Local Care Partnership.

However, until Home REIT was launched there was no critical mass provider of appropriate assets for short-stay accommodation. In our view, while there were serious failures in execution, the concept of investing in appropriate short-stay accommodation to generate viable medium-term revenues generating significant social impact is entirely sound.

It just needs a different model.

5. A sustainable model for Short Stay Supportive Housing.

There are a wide range of charities focused on Short Stay Supported Accommodation. They are generally thinly capitalised and focus on providing the care that is delivered alongside the provision of the assets.

25 year leases expose them to unacceptable capital risk since the contracts they operate with Local Authorities cover much shorter periods. However, aligning the maturities more closely with the care they provide is a viable solution. Agreement to longer-dated rental contracts also offers the Local Authorities certainty of supply while providing significant savings on rents, in higher quality and better maintained accommodation.

Prima face it appears in their interest to enter into new longer dated arrangements for the provision and management of the properties, overseen by a socially responsible and well capitalised landlord.

To make the model work requires a management team capable of:

- Identifying and/or developing the appropriate accommodation
- Maintaining it to a suitable standard
- Engaging with Local Authorities to assess demand
- Assessing the credit of the lessors/care providers

It then requires access to an adequate supply of capital.

In our view, this can be accessed under the right economic model from a mix of Charitable Trust Funds, Local Authority Pension Funds and other long-term investors in property assets. The participation of established Charities in the ownership of the fund would also help to underline its credentials.

An unlisted fund with an appropriate manager should then be able to raise capital as happens in the "private equity market" through a series of funding rounds:

- Where "in principle" commitments are made on the provision of funds
- Subject to drawdown as the money is required.

This will provide a stable long-term model for the provision of Short Term Supported Accommodation, capable of accessing a large supply of capital in an efficient and cost-effective manner and in the case of the Local Authority Pension Funds, delivering social impact into their geographic areas of concern.

If this is something potentially of interest, please connect with us as Allia C&C moves forward in fleshing out the concept.

[1] Taken from Home REIT Investor update presentations – latest September 2022

[2] Home REIT top 15 holders – see appendix

[3] A CIC is a limited company which can be "for-profit" so long as there is a benefit to the community served which must be its primary objective. CICs which can be companies limited by shares or guarantee, are subject to a range of corporate legislation and The Community Interest Company Regulations 2005.CICs are often not charities but are subject regulation by their own regulator, the Regulator of CICs. By its own admission, this is a "light touch".

[4] Taken from Home REIT's latest RNS on 2nd October 2023

Appendix:

Major holders in Home REIT at timeshares were suspended

	Holder	Percentage Holding
1	M&G	14.7%
2	Blackrock	11.86%
3	Vanguard	4.55%
4	J Safra Sarasin	3.91%
5	Charles Stanley	3.80%
6	Legal & General	3.52%
7	Alliance Trust	3.16%
8	Rathbones	3.08%
9	West Yorkshire PF	2.78%
10	JM Finn	2.00%
11	Wesleyan Assurance	1.68%
12	Liontrust	1.62%
13	South Yorkshire PF	1.52%
14	Redmayne Bentley	1.47%
15	Close Brothers	1.31%

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