Investment in Social Housing:
How institutional investors are investing in local communities
About Pension Insurance Corporation

Pension Insurance Corporation ("PIC") provides tailored pension insurance buyouts and buy-ins to the trustees and sponsors of UK defined benefit pension funds. PIC brings safety and security to scheme members' benefits through innovative, bespoke insurance solutions, which include deferred premiums and the use of company assets as part payment.

At 30 June 2016, PIC had £18.4 billion in assets backing the pensions of more than 130,000 policyholders. These assets are primarily invested in investment grade corporate bonds, UK government debt and cash. However, as a specialist pension insurer with liabilities analogous to those of a defined benefit pension scheme, PIC also invests in other forms of secure, long-term cash flows.

To date we have invested more than £500 million in debt issued by Housing Associations through direct deals, backing affordable housing up and down the country. With asset growth of around £5 billion in the past 18 months, PIC is a growing business with the expertise, desire and capacity to partner with Housing Associations on future deals.

PIC is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and Prudential Regulation Authority (FRN 454345). For further information please visit www.pensioncorporation.com
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Introduction

Housing Associations ("HAs") are independent, not-for-profit bodies that provide rented homes at sub-market rates, within a strong regulatory framework with implicit government support.

They can have a hugely positive role on the lives of residents and in the development of local communities, as well as the wider economy (see Figures 1 & 2). They can also be important partners for institutional investors, helping to support the pensions of millions of people around the country.

In order to gather background and data for this document, PIC sent a survey to our HA partners in the summer of 2016. We asked them about their outlook for the sector, their pipeline of projects, as well as their views on planning processes. The responses we received were surprising in the extent and breadth of the activities they provide for residents beyond providing subsidised places of residence. We were also heartened by the levels of economic and social benefit they strive to bring to local communities. There are many examples of best practice in this area contained in this document.

From the responses we received, it’s clear that all this doesn’t happen by accident. At their very best, HAs really do design their projects around the needs of the community. This might include for example,
providing at no cost community buildings for use by charities involved in training, skills development, provision of childcare and bereavement counselling for local residents. It might also include the provision of leisure facilities such as allotments, urban farms or arts theatres.

The best HAs are developing crucial links to local businesses at the early stages of their development projects, helping to create local jobs and apprenticeships. Even once the development phase has finished, they are providing ongoing benefit to the local economy. Indeed, in 2015 one third of all houses developed in the UK were built by HAs, so they have a crucial role to play. One HA that responded to our survey provided opportunities for more than 50 residents to find employment in 2015. Others have specific measures for the overall success of their development projects in part on the jobs created and the businesses supported.

This document is, in part, designed to highlight the best practice we at PIC see in our work with HAs in order that this can be shared and developed more widely.

This document is also designed to highlight the perhaps surprising perspective of those who work in HAs about the importance of their relationships with long-term investors, especially as banks are no longer able to lend at the same pre-crisis levels. These organisations have been clear to us that without the long-term relationships and security of financing that can be offered by institutional investors, development plans would need to be cancelled or scaled back. This can have a significant impact on the local community.

Links with the City and with institutional investors are therefore very important to HAs. These links feed directly into the wider social benefits that HAs bring to local communities.

What is clear from our conversations with the people who work for HAs is that they do not feel that story is well enough understood by important audiences, including politicians and indeed by their own residents.

Ultimately, this document is designed to provoke discussion and debate about this relationship and how institutional investors can best work with HAs, and vice-versa.

Figure 3.

1/3

of all houses built in the UK in 2015 were built by Housing Associations

Source: National Housing Federation ‘Housing Association Facts and figures’
Partnering with institutional investors

From an investment perspective, HAs have become an increasingly important partner for institutional investors, such as pension funds and insurance companies. This is because institutional investors with long-term liabilities need to match their pension payments with secure long-term cash-flows. The long-term nature of HAs means that they are able to offer investment opportunities, in the form of high quality, secure debt, at rates attractive to these investors in a world of low returns.

From the HA perspective, however, this is not a one way street: they need long-term relationships with stable lenders who are able to work with them to meet their funding needs with secure financing. This might include reducing the overall cost of borrowing, reducing the cost of carry and fully funding development aspirations.

There are certain steps that need to be considered on both sides if the relationship is to be a success.

Investors need to be clear why they are investing in HAs, and, as with other illiquid investments, need to put in time and effort to understand what they are investing in and the risks that are the counterpoint to the reward. Investors need to remember that just because a sector is regulated, there is no substitute for proper due diligence. To the contrary, regulations can be changed and, as we have seen over the past few years, this can change the investment case. For example, in his Summer Budget 2015, the then Chancellor, George Osborne MP, reversed a previously agreed policy of CPI plus 1% as the basis of rent increases for the subsequent decade. Instead, he announced that HA rents would decline on average by 12% over the four years to 2020-2021, forecast to benefit tenants by about £700 a year. Regulatory uncertainty has the potential to make some HAs appear a higher-risk investment.

Figure 4 shows how HA rent levels compare with other sectors, even in spite of the rent increases.

**Figure 4: Rental incomes 2008–2015**

Source: DCLG English housing survey 2014 to 2015
Likewise, changes in the macro-economic environment can also impact, for better or for worse, the case for investing in HAs. For example, following the (Brexit) referendum result, the UK was downgraded by rating agencies. As HAs are supported by the overall UK rating for their own ratings, this means that they were also impacted. If a particular investor is only able to invest in debt with a certain rating, this could rule out investing in HAs.

However, the fundamental investment case remains strong: the structural demand for housing (affordable or otherwise) in the UK. Indeed, in 2015 there were more than 1.2 million households on waiting lists for social housing in England, although this list is shorter than it might otherwise have been due to the effect of the Localism Act 2012. Ultimately, however, the sheer demand for housing helps to support the cash-flows generated by the underlying assets and HAs are a critical provider of housing in the UK (see Figures 5 & 6).

Figure 5: Affordable housing completions by HAs vs Total affordable completions

![Figure 5: Affordable housing completions by HAs vs Total affordable completions](Source: DCLG Live Table 209)

Figure 6: Social housing providers in the UK

![Figure 6: Social housing providers in the UK](Source: DCLG Live Table 209)
Case study – Pendleton Together

In 2013, PIC was the sole investor in £72 million of bonds backed by a project agreement with Salford City Council, to fund the New Pendleton Social Housing PFI project.

The funding is being used for the refurbishment of existing dwellings and associated infrastructure. The dwellings are a mix of high rise blocks and low rise terrace properties. The funds are being used by the project to refurbish about 1,250 existing dwellings in Salford, and to finance their maintenance over 30 years.

This project was delayed in early days due to uncertainty on funding availability both of PFI credits and long-term bank financing, so having the funding from PIC in place at the start of the contract provided the certainty and security that the project needed. On the back of this, other private funding has been levered, allowing for significant additional investment, improving the local geographic area in terms of appearance, economic activity, health and wellbeing improvements and job creation schemes.

In choosing to work with any potential client/borrower, the ability to build long-term relationships is critical to PIC.
Policy/ regulatory drivers

Institutional investors have to understand that the direction of policy and regulation can change quite suddenly, undercutting business models and affecting stakeholders in quite dramatic ways. A recent example of this is the Pension Freedoms introduced by the government in 2015. This radically altered the way that savers were able to use their pension pot and completely removed the obligation to purchase an annuity, dramatically altering the business models of some insurance companies.

We have not seen anything this radical in the social housing sector. However, the general tone of government policy has been to encourage a shift from social housing renting to more home ownership. They have also been keen to encourage HAs to streamline their cost base and increase merger activity across the sector.

These changes, including the 1% rent reduction for the next four years on the majority of social housing units, present both challenges and opportunities for investors.

Perhaps the most important point is that fundamentally, the rent reduction and squeeze on benefit levels will put financial pressure on HAs. On the face of it this should make their debt less attractive to investors. However, this isn’t necessarily the case as the sector responds in a variety of ways.

Those HAs with robust financials, good governance and sensible risk appetites should be able to successfully weather the changes, and indeed the sector is already showing signs of responding to the challenges. A strong case can be presented to potential financial partners by those HAs who can demonstrate they are well-prepared for the challenges ahead.

Others will be harder hit and the expectation is that we will see greater credit differentiation between HAs, as some will be better placed to respond to the changes than others. This may well lead to some HAs introducing more risk into their business model (e.g. through substantial development and sales exposure) to boost revenues. This means they will likely have to offer a higher yield on their debt. Whilst the increased yield versus government bonds on offer may be tempting to investors, especially in a world of negative sovereign bond yields, it is likely to be less attractive to institutional investors with a need to match assets and liabilities and strict regulatory frameworks with which they have to comply. Debt default is the greatest threat in this circumstance and whilst security structures can be negotiated (see section on working with prospective lenders), the balance of risk and reward will be carefully scrutinized on a case-by-case basis.
As a result of the policy changes, we would expect to see some further consolidation in the sector and an increased focus on higher levels of operational efficiency. Along with Right to Buy, which is generally considered credit positive as this may generate large cash windfalls for HAs, consolidation should be good for the sector as it will create larger, more stable HAs, and hopefully continue the trend of greater efficiencies being achieved by management across the sector.

Ultimately, whether consolidation happens or not, institutional investors will continue to work with HAs on their financing needs, despite the risk of further policy / regulatory changes. They will try to manage some of this risk, however, by focusing on high quality credits which are well placed to withstand potential changes.

"Without doubt, these recent changes in policy have been factored into future strategies, risk appetites and financial appraisals. What is not in doubt is the demand for new homes. In view of this, ways will be found to procure new dwellings but the mix/tenure might have to be altered to fit new political aims. When this is achieved, further debt funding will be needed."

Pendleton Together

Summary of policy/ regulatory change in the sector:

- 1% rent reduction for the next four years on the majority of social housing units
- Right to Buy – allows housing association tenants the right to buy their homes, albeit initial proposals have been watered down and it is now voluntary for HAs to sign up to this
- Pay to stay – requires higher income social housing tenants to pay increased levels of rent (HA participation is now voluntary)
- Benefit Cap – reduction in the benefit cap (the maximum amount of benefits that can be claimed) from £26k p.a. to £20k p.a. (£23k in London)
- Local Housing Allowance (LHA) caps – housing benefit will be capped for new entrants at the relevant LHA rate set for each area
- Deregulatory measures for the social housing regulator (the Homes and Communities Agency), to overturn the recent classification of HA debt on the government’s balance sheet
Case study – Grŵp Gwalia Cyf

Grŵp Gwalia Cyf (now part of the Pobl Group) is a leading provider of social housing in south and mid Wales, managing over 10,000 high quality affordable homes and meeting the needs of a broad and diverse range of people in the community. Following a recent merger (with Seren), The Pobl Group has responsibility for 16,000 properties. Gwalia agreed a £35 million loan with PIC in 2012, through private placement, to invest in affordable and social housing projects across south Wales, building approximately 250 new homes.

For Gwalia, certainty of funding was critical at outset to allow them to put their plans in place. However, having certainty of funding was a risk management strategy to cushion them as far as possible from regulatory and policy changes. In particular, they were concerned about the risk of an extension of rent controls to Wales, following the 1% rent reduction seen in England, which does not currently apply in the Principality.

For Gwalia, the action in England highlighted the risk of rent controls and increased their need for certainty of funding.

“When choosing a provider we are obviously focused on price. But of real importance is the ability to develop a long-term relationship with the funder, as well as their ability to be flexible in terms of structuring the finance package.”

Gwalia
Working with prospective lenders

From a practical perspective, how should a HA work with a prospective lender to ensure that they complete the deal on the best possible terms for both parties?

HAs should ideally have the ability to:

- Be flexible in the types of debt structures that can be accommodated – the final structure should work well for both parties
- Secure the debt to social housing assets
- Accommodate inflation-linked structures as well as more traditional fixed rate debt
- Maintain a strong investment grade equivalent rating
- Offer flexibility on maturity of debt to allow lenders to better match their liability profiles

Preparation is also key to ensuring that HAs get the very best deal they can. In particular they should:

- Have a strong management presentation
- Offer transparency
- Have clear but flexible timescales
- Have a willingness to build a long-term relationship
- Be prepared to include prepayment protection for the lender
Likewise, what should a HA expect from a lender?

Lenders can often accommodate investing in a range of structures. For example, lending directly to HAs or funding social housing development and regeneration schemes through a PFI model. This will of course depend on the expertise and risk tolerance of the lender in question, but ideally there should be opportunity to at least explore both options.

In assessing the level of expertise that a lender has, and hence how beneficial the relationship might be, HAs should check whether the lender has the flexibility to apply their own internal rating. This is important from a borrower’s perspective because it allows them to issue debt without having an external credit rating. This facility gives them flexibility around timelines for deal completion and indicates their level of sophistication and therefore the likelihood of them seeing the deal through to completion.

It is also worth seeing whether the lender can accommodate quite specific requirements, such as deferred draw down profiles. These offer flexibility to borrowers and provide certainty of funding whilst reducing the cost of carry. They are not, however, facilities which every lender will be able to accommodate.

When engaging on the direct side, lenders should be flexible on structure, to accommodate the needs of the HA. This might mean participating in public bonds, private placements, and loan structures. It should be noted that in most cases negotiation directly with an individual or club investor significantly reduces any potential execution risk from a transaction.

Institutional investors may also need the investment to be secured on social housing assets. This means that borrowers will be able to lend at a lower yield as there is ultimately less risk to the lender. For insurance companies this is particularly important.
Case study – mhs homes

In 2016, PIC invested £40 million in secured debt issued by mhs homes, a social housing provider based in Kent. Mhs homes are the largest independent landlord in Kent, owning and managing more than 8,500 homes in Medway, Maidstone and Dartford.

Key aspects of the transaction:

- £40m private placement, drawn in two stages over the next two years, giving mhs homes certainty of funding costs, whilst reducing the cost of carry
- Funding to help provide more than 400 new properties
- 34 year maturity (April 2050), to match PIC’s liabilities
- Secured on social housing properties

“This funding will help provide over 400 new properties in the Medway and surrounding areas. The flexible arrangements agreed with PIC meet the requirements of our business plan and provides the long term funding to match our aspirations.”

Bruce Shelmerdine, Finance Director at mhs homes

Figure 7.

Building long-term relationships

- **Investment from PIC** → **Housing provided** → **Wider community impact**

  - £40m
  - 400+ Homes provided
  - 48 work experience placements
  - 15 apprentices
  - 56 residents into employment

Source: MHS Homes Data (2016)
Case study – Investment in Church of England's Housing Assistance for the Retired Ministry

In 2015, PIC invested £70 million in secured debt issued by CHARM Finance Plc, to fund retirement housing in the CHARM (Church’s Housing Assistance for the Retired Ministry) scheme.

This scheme, provided by the Church of England Pensions Board (“CEPB”), offers subsidized retirement housing for clergy in the Church of England. The investment is linked to CPI and secured against a portfolio of residential assets. PIC was the sole investor.

For CHARM, the long term certainty of funding allowed them to move from a rate reviewed three monthly on the rolling credit facility. They were also happy with the inflation linkage, which is a good match for inflation linked rents. The funds also allowed them to buy out the Church Commissioners’ financial interest in properties that the Pensions Board considers to be long term holds and means they will enjoy the rewards and risks of ownership.
When designing the overall project, the wider needs of the community are integral and masterplan was subject to significant resident consultation. Input from local people help forge the long term plans.

The investment is resulting in new jobs and apprenticeships for local people.

Factors such as ease of access to services such as public transport, retail and healthcare are important.

320 properties have been insulated over the past 2 years and 160 double-glazed windows and doors installed.

New parks and allotments are bringing health and leisure benefits.

New jobs/apprenticeships in construction have been created but also in associated support areas such as catering and cleaning. Jobs have also been created in estate/management services.

Ongoing estate management is contributing to lower and anti-social behaviour, an increase in demand for dwellings.

Our environmental aims include energy efficiency as part of planned reinvestment.

When designing the overall project, the wider needs of the community are integral and masterplan was subject to significant resident consultation. Input from local people help forge the long term plans.

Aim to meet Decent Home Standards in newly acquired and re-let properties.

Best practice highlighted by our partners.
Our work plan over the next two years that link to our social and environmental activities will mainly fall into the following areas:

- To deliver great services
- To provide quality homes
- To help our customers achieve their potential
- To be financially fit and lean
- To have exceptional and diverse talent

We are also corporate partners with Medway UTC (a new technical school for 14-19 year olds specialising in Engineering, Construction and Design) and for 2016/17 we will be hosting 20 students for work experience and working with Mid Kent College on an academy for apprentices for our own in house maintenance team.

Our primary purpose is to alleviate the levels of homelessness and to provide a safe, affordable home to those most in need. Our added value activities often include personal support to help people with:

- Personal financial management
- Access to skills, training and employment
- Train people to engage with the digital world.

For all our maintenance and development contracts we seek one apprentice for every £1m of contract value. These are local apprentices. We also have our own programme of work experience, apprentices and interns across different teams. For the year 2015/16 we provided opportunities for:

- 48 work experience placements
- 15 apprentices
- 56 residents into employment

With any new homes development we research the likely demand, overall costs of construction vs the market value once completed. Certain locations are better suit certain tenures (Market rent/ and sale if for e.g. close to commuter hubs) and older persons accommodation if close to shops and medical facilities. All refurbishment and new build opportunities are fully appraised before being proposed and approved to ensure that the business and our communities are well served.