Update | REITs

19 February 2019

Civitas Social Housing

Regulatory action is positive

Civitas Social Housing (CSH) has met its dividend targets, grown its NAV and invested over £674m into 557 properties (housing almost 3,750 tenants) since launch. It has now merged its C share and ordinary share portfolios and is focused on optimising its capital structure (targeting 35% LTV), which should further strengthen its revenue account.

Over the past few months, a number of the Registered Providers (RPs) that are counterparties to CSH's leases have been issued with grading under review notices by the Regulator for Social Housing. This note addresses this issue and we seek to explain why the regulator's actions should have minimal direct impact on CSH but, in the medium-term, should serve to enhance the quality of its earnings.

Income and capital growth from social housing

CSH aims to provide its shareholders with an attractive level of income, together with the potential for capital growth from investing in a portfolio of social homes. The company expects that these will benefit from inflation adjusted long-term leases or occupancy agreements with Registered Providers and that they will deliver, on a fully-invested and geared basis, a targeted dividend yield of 5% per annum on the issue price. CSH intends to increase the dividend broadly in line with inflation.

Year ended	Price total return (%)	IFRS NAV total return (%)	IFRS adj. earnings per share (pence)	EPRA** earnings per share (pence)	Dividend per share (pence)
31/03/18*	(0.6)	10.7	2.60	1.44	4.25
31/03/19 *f*					*5.0*

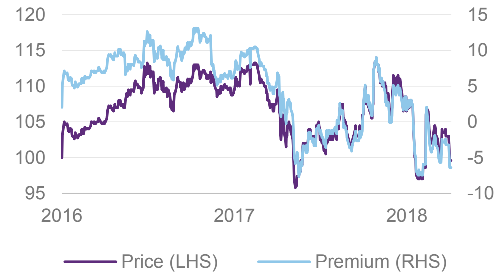
Source: Morningstar, Marten &Co. * from launch on 18 November 2016

Sector	Property - other
Ticker	CSH LN
Base currency	GBP
Price	99.6
IFRS NAV	106.5
Portfolio NAV	115.1
Premium/(discount)*	(6.5%)
Yield	5.0%

* based on IFRS NAV at 31 December 2018

Share price and discount

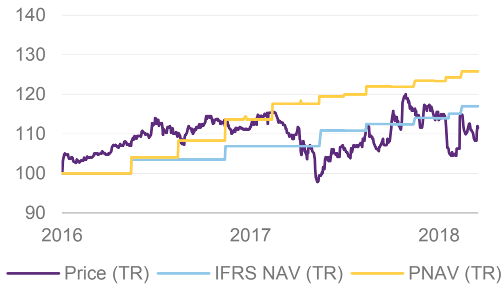
Time period 18/11/2016 to 18/02/2019



Source: Morningstar, Marten & Co

Performance since launch

Time period 18/11/2016 to 31/01/2019



Source: Morningstar, Marten & Co

Domicile	England and Wales
Inception date	18 November 2016
Investment adviser	Civitas Housing Advisors
Market cap	620.0m
Shares outstanding	622.5m

Click here for our initiation note

Portfolio construction on track

A brief recap of the structure of the specialist supported housing market; please read the initiation note for more detail

We explained the structure of the specialist supported housing market in the UK in our June 2018 initiation note. To recap, substantial savings are available to Local Authorities if they can rehome a person in need of supported living from a hospital into a property adapted to their needs. Research has also shown that these tenants then have an improved quality of life and better medical outcomes. Local Authorities turn to Care Providers to manage the day-to-day welfare of the tenant and to RPs to provide the accommodation. The RPs lease property on a long-term basis from the likes of CSH.

Figure 1: Portfolio progression since launch

Period	31/03/17	30/06/17	30/09/17	31/12/17	31/03/18	30/06/18	30/09/18	31/12/18
Investment (GBPm)	106	206	284	421	472	508	619	674
Properties	82	167	282	384	414	440	521	557
Tenancies	487	1,130	1,820	2,405	2,621	2,845	3,440	3,746
Local Authorities	32	68	82	99	109	123	140	144
Registered Providers	5	7	10	10	11	12	15	15
Care Providers	25	42	50	59	64	71	93	98

Source: Civitas Social Housing

£674m deployed, targeting 35% LTV

At the end of December 2018, CSH had deployed £674m (excluding purchase costs), more than the £652m it raised from investors in two issues (the IPO in November 2016 and the C share issue in November 2017). The balance has been met from CSH's borrowing facilities. To date, these comprise a £52.5m 10-year facility from Scottish Widows fixed at 2.9936%, a £60m three-year revolving facility supplied by Lloyds Bank at LIBOR +1.5%, and a £100m three-year, floating-rate, revolving credit facility from HSBC.

Further finance will be sought to raise the LTV to 35%. Each rental transaction has been entered into at yields well in excess of CSH's weighted average interest cost and, therefore, all things being equal, dividend cover will improve as the remainder of CSH's firepower is deployed.

Larger transactions under consideration

The advisers (Civitas Housing Advisors) have been acquiring properties in small lot sizes but the advisers say that they are now looking at larger transactions. They note that some care providers that have built medium-sized portfolios are now looking to restructure their operations to be less capital intensive. They are willing to divest supported living properties, and these may become available to CSH.

Tenancies are for the lifetime or substantially all of the lifetime of the tenant, and leases are long (the WAULT at the end of December 2018 was 24.7 years). Once established, there is unlikely to be much turnover in the portfolio. We are encouraged, however, that the adviser is prepared to roll up its sleeves and help RPs reposition underperforming assets. A recent example of this was the reconfiguration of an underutilised women's refuge into what is now a very well-used mental health unit.

The adviser has been growing its team

As the adviser's responsibilities grow, it has been expanding its team. Recent additions include Steve Travers (ex-CEO of Pathways Care Group and ex-group corporate development director for The Priory Group), Simon Cairns (ex-Pradera) and Thomas Powell (ex-Jones Lang LaSalle). In addition, the adviser has been seconding people into its transaction team from the major law firms.

Regulatory action

The 'hit' from First Priority was minimal

Much has been made, in some quarters, of the Regulator for Social Housing issuing 'grading under review notices' (on a selection of CSH's RPs). The first of these to hit headlines was First Priority. In our initiation note, we explained the reasons why First Priority Housing ran into trouble and the steps that CSH took to resolve the situation. We also highlighted that the monetary impact was minimal – the adviser estimated around £300,000 or 0.05% of NAV and expected that some or all of this might be recoverable at a later date. More importantly, none of the tenants were affected in any way by the collapse of First Priority and the subsequent assignment of its leases.

Four more of CSH's RPs have been or are under review by the regulator

We noted that First Priority was something of a worst-case scenario for CSH. Subsequent to our last note, the regulator issued notices on Westmoreland Supported Housing, Inclusion Housing CIC, Trinity Housing Association, and Bespoke Supportive Tenancies – all of which feature in the CSH portfolio. This is not a cause for alarm. In conjunction with CSH and other investors in the sector, some of these RPs have been expanding rapidly. Standards of record-keeping, financial management and corporate governance have not always kept up. The regulator is taking steps to improve the professionalism and efficiency of RPs, and it is starting with the largest of these.

CSH and the regulator share the same ambition to raise standards

CSH and the regulator share the same ambition to raise standards. The advisers have been working with their RPs to improve record-keeping, bring experienced and knowledgeable non-executive directors onto boards and improve standards of disclosure. CSH expects that, eventually, every RP that it works with will be reviewed by the regulator. CSH also seeks to structure its deals in a way that seeks to enhance the stability of the RPs, recognising the fact that they are signing long leases.

No impact on CSH NAV

As discussed on page 10 of our June 2018 initiation note, Jones Lang LaSalle (JLL) values CSH's property portfolio on a quarterly basis, using a standard RICS 'Red Book' method which is based on discounted cash-flows. In computing these valuations, JLL has not thought it necessary to reduce valuations in respect of any of these grading under review notices and, consequently, there has been no downward pressure on CSH's NAV. The rationale is that the tenants remain in place and the underlying cashflows are unchanged as a result of a notice being issued.

As examples of improved corporate governance, Trinity Housing brought in a number of new outside directors, strengthening its board. Falcon has appointed a new CEO who used to hold a senior position at Places for People (one of the largest housing associations in the UK).

The advisers do not expect any change to industry framework. It is true that the RPs are thinly capitalised, but they will remain so. The advisers have encouraged the RPs that CSH deals with to hold more money in reserve, in escrow accounts if possible, to guard against unforeseen voids in the portfolio.

Managing voids and collecting the rent

It is important that RPs manage voids in their portfolio quickly and efficiently

Voids are the biggest financial threat that RPs face (paying rent on a near-empty building can soon leave a hole in their finances). It is therefore important that the RPs are providing accommodation that meets the needs of prospective tenants and meets the standards required by the local authorities, who cover the cost of the rent. RPs must also be responsive to the requests of the local authorities and disagreements (over things such as building maintenance) must be dealt with quickly and efficiently.

Care providers cover cost of some voids – to ensure properties are available at short notice

Voids are a fact of life in almost any property investment. However, once a specialist supported housing property has been brought fully into the system, it should experience lower turnover than general needs housing and should therefore experience lower voids as a result. Generally, tenants do not want to move, and the local authorities know that moving them can have adverse effects on care outcomes. This is a consideration for care providers as well. They want to be able to demonstrate positive outcomes for the tenant as this is a factor on which they are judged by local authorities. They monitor and record every aspect of the tenant's life to ensure that, where possible, the tenant's quality of life is improving. If a tenant is in good surroundings and a well-maintained building, this may benefit their quality of life. Overall therefore, the focus is on more than just price. Furthermore, the care provider will typically agree to cover the first couple of voids in their part of the portfolio as they want the flexibility to place someone at short notice.

Timely rent collection is important; CSH is often cushioned by provisions against voids

RPs also need to be on top of rent collection. Anecdotally, some local authorities are notoriously late payers and CSH has actively avoided these within its portfolio. Rent arrears can put a strain on an RP's finances, which could impair its ability to pay rent to CSH. The adviser has encouraged the creation of void funds by vendors of properties for the benefit of the RPs. The RPs can tap into these when necessary. The funds typically comprise between three and 12 months' money to cover voids and late payments. This is one reason why CSH has no rent arrears across its entire portfolio.

CSH always checks that rents are reasonable and rejects properties that it feels are overrented

It is true that rents on supported living properties are higher than equivalent rents for standard housing but this in accordance with legislation dating from 1996, which stated that providers of specialist accommodation were permitted to charge rents commensurate with the extra level of services and specialist nature of the accommodation. CSH always checks that rents are reasonable in the context of rental rates for similar properties in the area. It has rejected potential acquisitions on the grounds that they are overrented.

General shortage of supported living accommodation looks set to continue for the foreseeable future

Rents might conceivably come under pressure if there were a substantial oversupply of supported living properties. The advisers say that there are no areas within CSH's portfolio where this looks likely to be an issue for the foreseeable future. There are some pockets of the country where supply is adequate but growing demand for supported living places might soon absorb this.

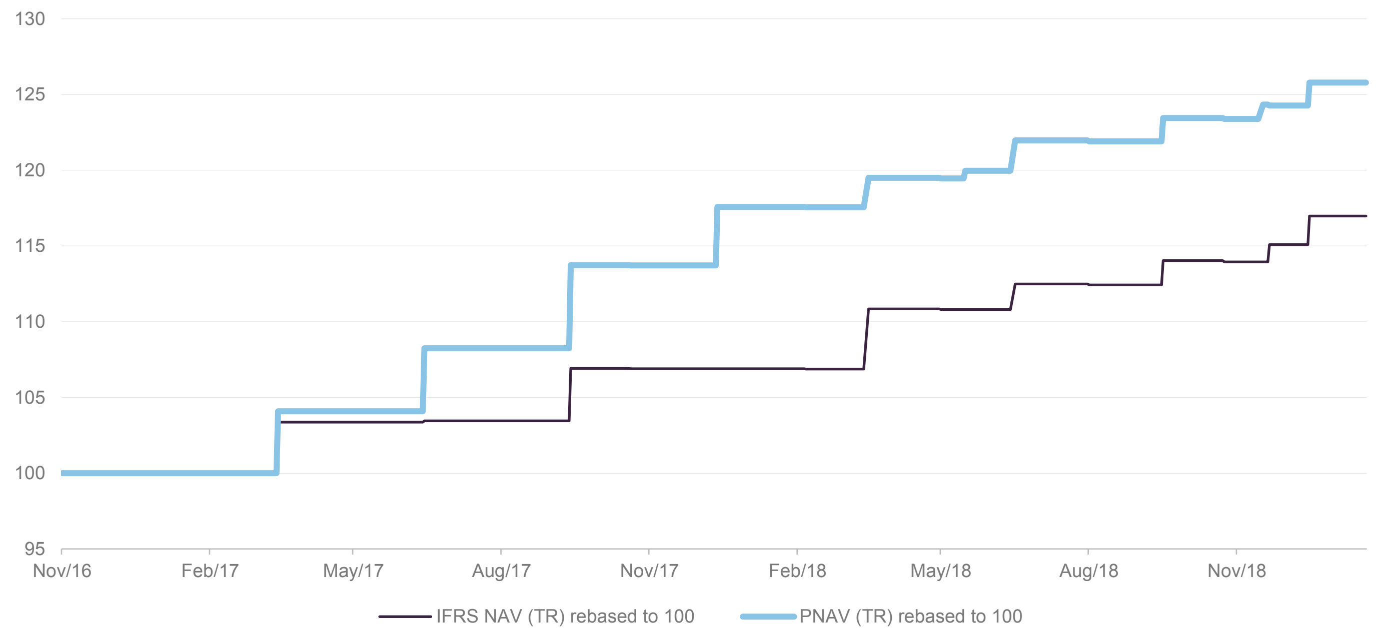
Performance

CSH's total returns continue their steady upward march (see Figure 2). At the end of December 2018, CSH's IFRS NAV per share was 106.5p, up from 106.1p at the end of September 2018. On a portfolio basis, the ordinary share NAV was 115.1p, down from 115.2p at the end of September 2018. For a full explanation of the difference between portfolio NAV and IFRS NAV, please see our initiation note, but in simple terms, the IFRS NAV represents the value that might be achievable if the portfolio was sold piecemeal and the portfolio NAV is what you might get if the entire portfolio was sold in one transaction.

Our previous note discussed the issues around First Priority and the steps that CSH took to rectify the situation; as we pointed out on page 3, the impact on the NAV was minimal. Nevertheless, a few investors appeared to take fright once again when CSH drew attention to Westmoreland's grading under review notice in its interim accounts published at the end of November. Once investors had reassured themselves that this was unlikely to have a material impact on CSH, the share price rebounded (see Figure

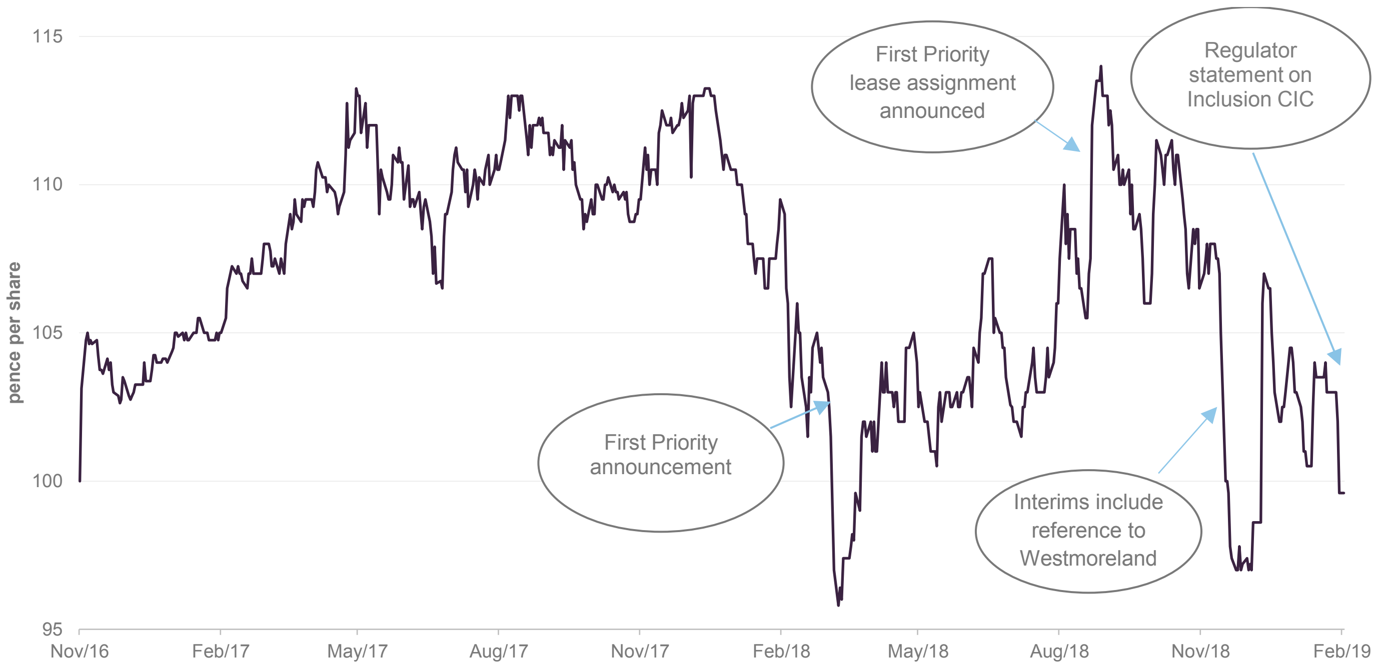
3). Subsequent price moves on the back of review notices have not been as savage, but perhaps they still represent a buying opportunity.

Figure 2: CSH ordinary share NAV total return (including dividends reinvested) since launch



Source: Civitas Social Housing, Marten & Co

Figure 3: CSH share price since launch



Source: Morningstar, Marten & Co

Peer group

You can access up-to-date information on CSH and its peers on the QuotedData website

CSH sits within a small group of listed peers comprising Triple Point Social Housing REIT (SOHO) and Residential Secure Income REIT (RESI). CSH is by far the largest fund in this peer group. RESI's focus is more on retirement properties and shared ownership housing, and therefore SOHO is a better comparator.

Figure 4: Peer group comparison as at 18 February 2019

Heading	Market cap (£m)	Premium/ (Discount) (%)	Yield* (%)	Launch date
Civitas Social Housing	620	(6.5)	5.0	18/11/16
Residential Secure Income REIT	158	(11.5)	5.4	12/07/17
Triple Point Social Housing REIT	353	(1.1)	5.0	08/08/17

Source: Morningstar, Marten & Co, * based on targeted dividend

Premium/(discount)

Figure 5: CSH ordinary share premium/discount to IFRS NAV since launch

Source: Civitas Social Housing, Morningstar, Marten & Co

CSH's ordinary shares traded at a premium to its IFRS NAV for most of its life, but the issues around the grading under review notices that we have discussed on page 3 unnerved some investors and increased share price volatility. Over the year to the end of January 2019, the discount moved within a range of -7.7% to +9.0%. At 18 February 2019, the discount was 6.5%, well below its average since launch.

Fund profile

The company's website is www.civitassocialhousing.com

CSH launched on 18 November 2016, raising £350m. It expanded through the issue of a C share in November 2017. This issue raised an additional £302m. The two pools were merged at the end of November 2018.

Attractive yield, growing with inflation, plus capital growth from a portfolio of social homes

CSH aims to provide an attractive yield, growing in line with inflation, and the prospect of capital growth. It buys portfolios of social homes in England and Wales which it rents to housing associations and local authorities (Registered Providers) on long-term (typically 10 – 40 years) leases. CSH buys only completed homes and is not involved with developing, forward financing or managing social homes directly.

CSH believes that the returns on its portfolio should have a low correlation to those of the general residential and commercial property sectors. CSH invests in such a way that it should remain qualified as a REIT. As such, it distributes at least 90% of its income profits for each accounting period.

The adviser: Civitas Housing Advisors

CSH is advised by Civitas Housing Advisors (CHA), a business established in 2016. CHA's 17-strong team is based in London and the north-west of England. Many of the team have long experience of working in the sector and, collectively, they have been involved in the acquisition, sale and management of over 80,000 social homes in the UK.

Previous publications

We published an initiation note on CSH – **Socially beneficial investing** – on 18 June 2018. This explains in some detail the supported living market in the UK and CSH's position within it, the structure of the fund (including fees, capital structure, advisory team and board) and the adviser's investment process. You can read the note by clicking on the link above or by visiting our website, **www.martenandco.com**.

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IMPORTANT INFORMATION