THE GOOD ECONOMY

BIG SOCIETY CAPITAL

AFFORDABLE HOUSING EQUITY INVESTMENT MODELS: OPTIMISING RISK, RETURN AND IMPACT

INSIGHT BRIEF

JULY 2021

ABOUT BIG SOCIETY CAPITAL

Big Society Capital (BSC) is the leading financial institution dedicated to social impact investment in the UK and a specialist impact investor in UK housing. Since inception in 2012, BSC has committed almost £150m to help catalyse and scale innovative business models providing homes for the most vulnerable and unlocking impact-led capital from institutional investors to scale business models that can drive systemic change.

Our vision is to help build a housing system centred on impact that addresses social need and improves lives. Through our investments and work with others we seek to grow and evolve the housing investment market by shaping understanding of best-in-class business models, deepening focus on impact measurement and supporting others to allocate more effectively to impact outcomes.

ABOUT THE GOOD ECONOMY

The Good Economy (TGE) is a leading social advisory firm dedicated to enhancing the contribution of business and finance to inclusive and sustainable development. Formed in 2015, TGE has established itself as a trusted advisor working with private, public and social sector clients. We provide impact measurement, management and reporting services that help our clients to understand, enhance and communicate their impact with integrity and confidence. We currently provide impact services for affordable housing investment managers with over £3 billion assets under management.

We also contribute to thought leadership through our collaborative projects. Our intention is to support the development of impact investing so it scales with integrity and delivers meaningful social change and positive place-based impact.

PROJECT GROUP MEMBERS

Association of Real Estate Funds (AREF)
BMO Real Estate Partners
Civitas Investment Management
Funding Affordable Homes
LaSalle Investment Management
M&G Real Estate
Man Group
Nuveen Real Estate
PGIM Real Estate
Resonance Limited
Triple Point Investment Management
Towers and Hamlins

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FOREWORD

Big Society Capital and The Good Economy believe now is the time to set new norms to ensure private capital is a positive force in tackling the need for more social and affordable housing.

The UK social and affordable housing sector has a clear mission: to supply secure, quality, and affordable homes across the UK to the millions of people who need them. But the challenges it seeks to address are substantial and rising, encompassing homelessness, social care and the continued undersupply of genuinely affordable homes. As the need for new sources of finance into the sector grows, the sector requires capital markets and capital partners that support and share in this mission.

A confluence of factors has led to growing commercial investor interest in social and affordable housing. Long-term capital from institutional investors is well-aligned to the long-term nature and needs of the social housing sector and much of the current funding is characterised by strong and productive partnerships with investors based on shared objectives. However, this is not automatically the case.

We believe the market for investment in social and affordable housing needs to be underpinned by 'rules of the game' to help ensure that intentions are always clear, incentives are aligned, and there is transparency and accountability to all stakeholders, including residents. Now is the time to set these norms, to mitigate negative risks, and encourage investment flows that make a positive contribution to increasing the supply and quality of affordable housing over the long term for those most in need.

Big Society Capital and The Good Economy have partnered with stakeholders from both the social housing and financial sectors to establish these new norms and codify best practice, building them around the linked practices of ESG Reporting and Impact Management. This started with the publication of the **ESG Sustainability Reporting Standard (SRS) for Social Housing** in November 2020, a voluntary ESG reporting standard, covering 48 criteria across ESG considerations such as affordability, safety standards and energy efficiency. Second has been the development of an Impact Reporting Framework for housing investment funds that are seeking to make a positive difference to people and the planet. The purpose of this framework is to identify and characterise the opportunities for impact additionality that emerge in partnerships between housing investment funds and housing providers, and to report on that impact in a consistent and transparent way. This framework is published in the document: **"Towards an Approach to Impact Reporting for Investments in Social and Affordable Housing".**

Lastly, there is a recognition across the social housing sector of some opaqueness and concerns about the nature and range of investment models that exist, what constitutes 'good' and 'bad' practice and the risks and opportunities of 'equity-type' capital. This is the focus of this insight brief: **"Equity Investment Models in Affordable Housing: Optimising Risk, Return and Impact"**, which seeks to highlight the issues and provides a descriptive framework that aims to bring greater transparency to the equity fund landscape.

With the publication of the Impact Reporting Framework and this Insight Brief, the aim is to lay the foundations for a social and affordable housing investment landscape that always supports the social housing sector to deliver on its mission and is underpinned by shared norms that promote transparency and accountability. It is a sobering fact that approaching 100,000 households spend each night in temporary accommodation in the UK, double the number seen 10 years ago. When provided in a socially responsible way, private capital has the potential to significantly support the social housing sector's efforts to address the housing crisis faced by these families and many more throughout the UK.

Now is the time to set these norms, to mitigate negative risks, and encourage investment flows that make a positive contribution to increasing the supply and quality of affordable housing over the long term for those most in need.

PURPOSE OF THIS REPORT

In recent years, the social housing sector has seen the entrance and rise of private equity-funding models bringing new sources of capital and new business models to the sector. This includes the launch of affordable housing investment funds by both specialist investment managers and established global real estate investors, raising long-term institutional investment as well as the establishment of for-profit Registered Providers (RPs). These funds have different investment strategies from investing in affordable rent or ownership to specialised supported housing to homelessness accommodation. While these equity-funding models bring opportunities for the sector, they also bring risks.

Ultimately, the motivations underpinning private investment into the social and affordable housing sector is critical. It is of fundamental importance that equity funding is aligned with and supportive of creating long-term positive impact for housing providers and their residents, and that financial risks and returns are fairly shared. We believe an impact investing approach is needed when investing in social and affordable housing. Impact investments are investments made with the intention to generate positive measurable social and environmental impact, alongside financial returns. Impact investing requires integrating impact considerations into the investment process and measuring and reporting on impact performance.

Big Society Capital and The Good Economy have developed an approach to impact reporting – see "Towards an Approach to Impact Reporting for Investments in Social and Affordable Housing" together with fund managers. The purpose of this paper is to provide a companion piece looking more explicitly at equity investment models from a risk, return and impact perspective so as to build shared market understanding and knowledge of these new and emerging financing models.

Expected beneficiaries of the framework will be fund managers who can use the framework to describe the features of their investment strategy in a clear and transparent manner; housing providers seeking capital who will be better equipped to understand different investment models and find aligned investment partners; and asset owners who will benefit from greater market understanding and insight into the characteristics of different investment funds.

We welcome comments and feedback.

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EXECUTIVE SUMMARY

What value do the many new sources of capital entering the social housing market bring, and does this justify the returns they generate? One constructive way of answering this crucial question – crucial because the UK is unlikely to solve its housing crisis without support for the efforts of Registered Providers of social housing (RPs) from private 'equity-style' housing investment funds – is provided by the descriptive framework of investment models developed by Big Society Capital and The Good Economy.

While housing investment funds are enabling affordable housing projects to go ahead that otherwise wouldn't have been built, it is important that they also share traditional RPs' impact-focus. That means holding them to high standards of transparency and integrity.

The descriptive framework tool brings greater transparency to the market by:

- Enabling housing investment managers to describe their investment models clearly.
- Supporting housing partners' understanding of funding models and capacity to question potential investors.
- Helping asset owners deepen their understanding of models and ability to differentiate between funds.

Besides ownership, it focuses on two broad dimensions:

- **Contribution** – How directly engaged is the housing investment fund in delivering additional supply and raising the quality of homes? What is their involvement in the scheme design and housing management? How are they adding value that enables the housing provider to deliver greater impact?
- **Risk and Return** – Which risks is the investor managing and which are borne by partners, or otherwise mitigated? Do the potential financial returns align with this level of risk? Are risks and returns shared fairly?

Equally, we recognise the need for a consistent approach in how housing investment funds report on their making a positive difference to people and the planet. This enables capital to flow towards funds with the greatest impact, as well as helping housing partners make informed decisions about who they work with.

Big Society Capital and The Good Economy partnered with 10 housing investment managers, as well as other key sector stakeholders, in developing this consistent impact reporting approach. It is presented in the accompanying publication '**Towards an Approach to Impact Reporting for Investments in Social and Affordable Housing**'.

	RISK TAKEN BY THE FUND AND INVESTORS		RISK TAKEN BY PARTNERS
Planning / development risk	Funding the development of new homes that wouldn't otherwise have been built. including development risk (e.g. new land-led development).	⟷	Fund aims to minimise risk and takes no development or planning risk. Only buying homes that are already built.
Political and Regulation risk	Fund accepts the risk of government policy change (e.g. paying fire remediation costs).	⟷	Housing partner takes on all risks of change in regulation.
Rent policy risk	Fund take on risk of rest policy change (eg. freezing housing benefits, or change to inflation linkage).	⟷	Housing partner bears all risks of policy change, (e.g. rent increases to fund are set at CPI +1% with no flexibility).
Repair risk	Fund takes on all repair risk (e.g. bearing all cost of unexpected repairs).	⟷	FRI contracts are agreed with all housing partners.
Void risk	Fund takes on all risk of voids, through direct tenancies, management agreements or flexible leases to housing providers.	⟷	Housing partners take all void risks, with very limited initial allowances or ability to break.
Sales risk (where relevant)	Fund takes on all sales risk.	⟷	Housing partners take all risks associated with slow sales.

1. INTRODUCTION

MARKET CONTEXT

THE UK IS EXPERIENCING A HOUSING CRISIS

The UK is in the midst of a housing crisis. According to the National Housing Federation, this is affecting nearly 8 million people, one in every seven people. An estimated 3.4 million people live in substandard or overcrowded accommodation, 2.6 million are unable to afford to buy or rent, with over one million people stuck on local authority housing waiting lists and 0.4 million people are homeless or at risk of homelessness, with fears that this number will rise as Covid restrictions on evictions are lifted.

The social housing sector has a vital role to play in helping to meet housing need. Registered housing providers, local authorities and charities provide over 5 million homes for people who are unable to afford to rent or buy in the open market. There is an urgent need to increase the supply of quality, affordable homes. Research from the National Housing Federation highlights that £12.8bn is needed each year for the next 10 years to adequately respond to the undersupply of affordable homes.[1] In addition, the social housing sector faces the challenge of meeting net zero targets. It is estimated that the cost of decarbonising the UK's housing stock is as high as £104bn.[2] Furthermore, the global pandemic has created additional pressures on mainstream tenants, with social housing rent arrears reaching £1bn and increased pressure on the additional support services that RPs seek to offer.

NEW TYPES AND SOURCES OF CAPITAL ARE ENTERING THE SOCIAL HOUSING MARKET

Debt finance has been the predominant source of private funding for social, affordable, and supported housing for decades. The Housing Act of 1988 saw Housing Associations legally redefined as non-public bodies, allowing them to access private finance in the face of constrained public sector borrowing. Since then, the supply of debt finance has risen rapidly. This supply has been driven by low interest rates and the ability of RPs to leverage large balance sheets to secure affordable loans to meet the growing demand for social housing, including through listed bond issuance. Drawn debt levels stand in the region of £80 billion as of 2019. The recent rise in issuance of sustainability-linked loans and sustainability and social bonds has served to highlight the potential of social and affordable housing as an investment opportunity that delivers both strong financial and ESG performance. The Good Economy led the development of the Sustainability Reporting Standard for Social Housing, as a sector-standard ESG reporting framework which can help housing associations demonstrate their ESG credentials (see box).

At the same time, a low interest rate environment has led institutional investors to search for higher yielding assets than traditional debt. Social and affordable housing has become a new investment opportunity for investors seeking inflation-linkage, diversified cashflows and low correlation with economic cycles.

SUSTAINABILITY REPORTING STANDARD FOR SOCIAL HOUSING

During 2019-2020, The Good Economy (TGE) facilitated the development of an ESG reporting standard for social and affordable housing using a collaborative and participatory process involving both the social housing and financial sectors. This resulted in the publication of the Sustainability Reporting Standard (SRS) for Social Housing in November 2020 as a voluntary reporting standard, covering 48 criteria across ESG considerations such as zero carbon targets, affordability and safety standards.

The SRS will be overseen and further developed by the Social and Affordable Housing: Sustainability Reporting Standards Board. Currently, more than 85 Registered Providers of social housing (RPs) and financial institutions have become early adopters of the Standard. Further information on the SRS can be found here.

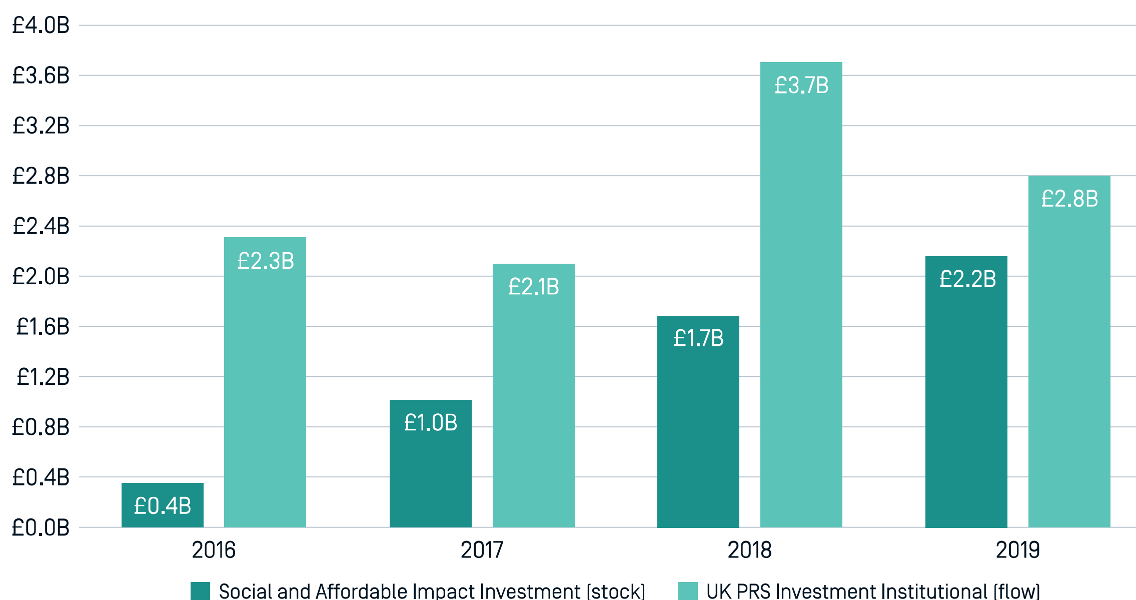
AFFORDABLE HOUSING INVESTMENT FUNDS ARE ON THE RISE

The convergence of the search for yield and impact has led to the launch of multiple new social and affordable housing funds in the last few years. The basic investment model is that the investor buys property for social use, retains ownership and receives the rental income to provide a yield. Rental income is predominantly from government housing benefit which supports eligible residents whose incomes are too low to meet the full cost of housing themselves. These rents are often tied to annual inflationary increases. Investors are attracted by the stable, long-term financial returns, including capital appreciation. Typical returns range between 5% and 8% depending on leverage, development risk and the underlying yields on different types of housing tenure (e.g. social rent vs. affordable rent).

BSC estimates that more than £2.2 bn of this type of impact capital has been deployed since 2014, although the number is larger if all equity-type capital is included.[3] This is approaching comparability with the flow of institutional investment into the Private Rented Sector (PRS), however it is still relatively small compared to the £13bn of additional debt raised by RPs in 2019 alone (see Figure 1).

1. Briefing: How many people need a social rented home, National Housing Federation, September 2019.
2. https://www.insidehousing.co.uk/insight/insight/the-cost-of-net-zero-social-landlords-decarbonisation-plans-revealed-68497.
3. Based on respondents to BSC's Market Sizing Estimate. https://public.tableau.com/profile/big.society.capital#!/vizhome/2019MarketSizing/2019MarketSizing.

Figure 1 – Impact Investments in Social Housing vs Institutional investments into PRS



Source: Big Society Capital, Market Sizing Report, October 2020; Knight Frank Research / RCA, 2020.

SOCIAL AND AFFORDABLE HOUSING INVESTMENT FUNDS – EXAMPLES OF LAUNCHES

- In 2014, Cheyne Capital launched its Social Property Impact Fund aiming to tackle chronic shortages in housing for disadvantaged groups. The fund is now exiting and has c.£160m AUM, with a follow-on fund launched in 2020 with £150m of investor commitments.
- In 2015, Funding Affordable Homes (FAH) was established, the first social property fund with its own housing provider, Funding Affordable Homes Housing Association (FAHHA). As of end 2020 FAH had a Gross Development Value of c.£170m AUM.
- 2016 saw the launch of the Civitas Social Housing REIT, the first social housing REIT focused on Specialised Supported Housing. The Civitas Social Housing REIT has £1.04bn AUM as of March 2021.
- In 2017, Blackstone acquired a 90% equity stake in Sage, a For-Profit Registered Provider (FPRP). They acquire homes in England predominately through Section 106 agreements. As of 2019, Sage had £419m AUM.
- In 2018, CBRE Global investors launched their UK Affordable Housing Fund, raising around £250m, which both acquires existing housing stock and provides forward funding for new developments.
- In 2018, L&G launched L&G Affordable Homes, its For-Profit RP, with initial investor contributions of £175m and a further £100m of debt from an L&G pension fund in 2020.
- In 2019, BMO launched a new fund targeting £300m of institutional investor capital. The Build to Rent (BTR) fund uses BMO's innovative Flexi-Rent model aimed at ensuring that rents do not outpace inflation for lower and middle income households.
- In 2021, Man Group raised the first part of a targeted £400m raise aiming to build 3,500 homes including receiving investment from Swansea and Strathclyde LGPS and from Homes England.
- In 2021, PGIM Real Estate launched its UK Affordable Housing Fund attracting £190m of commitments including from two local government pension pools, the Northern LGPS and Brunel Pension Partnership.
- In 2021, Resonance launched two homelessness property funds in London and Greater Manchester with investment from Social Investors, Local Authorities, and pension funds. Since 2012 Resonance has invested over £200m acquiring around 1,000 homes for people at risk of homelessness across England.

This coincides with a challenging period for RPs as they seek to grow their stock while faced with the growing costs of new environmental, fire-safety and other regulatory standards. Equity funding brings an alternative to debt finance and opens up opportunities for RPs to access new sources of capital and form new funding partnerships to meet their business objectives. See table below for the motivating factors driving the interest in equity funding models by different market participants.

MOTIVATING FACTORS OF PRIVATE "EQUITY-TYPE" FINANCING OF SOCIAL HOUSING	
Asset owners / institutional investors	■ Stable, long-term, inflation-linked income well-suited to pension and other long-term investors ■ Diversified cashflows, within and beyond real estate ■ Low correlation with economic cycles ■ Stable tenancy rates with low levels of voids (less than 1.5% over past 5 years) ■ Increasing allocations to ESG and/or impact
Investment managers	■ Undersupply of equity capital to market with attractive financial characteristics and high social impact provides investment opportunity ■ Strong client demand for long-term, income-generating investment products that have positive ESG or impact performance ■ Strong supply and demand dynamics, high local authority wating lists and aspirational government targets matched with limited public funding ■ Availability of grant for some tenures i.e. Section 106 and Shared Ownership ■ Opportunity to contribute to positive impact in an area of important social need. Range of niche but scalable investment strategies possible (see Chapter 2)
Registered Providers and other mission-led housing orgs	■ Limited borrowing capacity, esp. small and medium sized RPs, hence looking for alternative funding options to deliver growth plans ■ Opportunity to engage in partnerships which share risk and bring complementary skills and resources (e.g. via Joint ventures) ■ Opportunity to develop new homes that do not have in-house capacity to do alone (smaller providers)

COMMON IMPACT FRAMEWORKS CAN BE USED TO INCREASE THE POSITIVE IMPACT HAD BY PRIVATE CAPITAL

The scale of interest, the convergence around impact opportunities and the nascent nature of the market provide an opportunity to shape a housing finance market that is focused on achieving positive real-world outcomes for people in housing need, while also providing appropriate risk-adjusted return to investors and helping to meet the UK's high demand for social housing. Institutional investors bring long-term capital that is well-aligned to the long-term nature of the social housing sector and have a greater focus on quality than many private rented sector landlords. But it is critical that all actors in this arena have strong ethical values, act responsibly and build trust.

The impact reporting approach developed by Big Society Capital and The Good Economy (found in the report "Towards an Approach to Impact Reporting for Investments in Social and Affordable Housing"), was developed as a way to help housing investment funds account for their 'additionality' - the impact over and above what would otherwise have occurred. Its purpose is also to provide consistent benchmarkable data that could be used to compare and contrast impact performance using standardised metrics.

The scale of interest, the convergence around impact opportunities and the nascent nature of the market provide an opportunity to shape a housing finance market that is focused on achieving positive real-world outcomes for people in housing need, while also providing appropriate risk-adjusted return to investors and helping to meet the UK's high demand for social housing.

TO MITIGATE IMPACT RISKS – AND ENSURE THAT THE CAPITAL IS GENUINELY COMMITTED TO DELIVERING IMPACT – IT IS ESSENTIAL THAT WE HOLD SUCH INVESTMENTS AND INVESTORS TO HIGH STANDARDS OF TRANSPARENCY AND INTEGRITY

Despite the impact intentions of many housing investment funds, there are a number of risks that have to be considered and which have created market concerns, particularly given the fact that social housing is essentially a public good funded by public money. These concerns centre around three areas:

- **Arms-length ownership of social housing by private investors.**[4] There are concerns regarding the ownership of social housing by private investors who may regard social homes purely as financial assets generating yield with little concern for the welfare of residents or the situation of their leaseholder housing partners. Well-publicised failures in care provision and quality of property management in investor-owned properties housing the most vulnerable in society reinforce a fear of the negative effects of the 'financialisation' of housing and care.
- **Public revenue is underpinning private returns to shareholders**:[5] Concerns exist that taxpayers' money is being used to generate excessive investor profits; that investors will make investment decisions driven by a focus on maximising financial returns rather than creating social value and sharing risks and returns fairly with social housing providers and ensuring rents are genuinely affordable.
- **Systemic risk of lease-based models**:[6] Concern that RPs are contractually tying themselves to long-term, index-linked obligations to investors without the corresponding revenue security, hence may have liabilities that put the organisation at financial and operational risk.

These risks and issues reinforce what can go wrong when there is a lack of alignment of financial incentives, risk-taking and real-world consequences. As well as the harm that can be caused to the people and housing organisations concerned, the effect of a reactionary government or regulatory intervention in response to these issues can end up putting a lid on good as well as bad activity.

THE RELATIONSHIP BETWEEN A HOUSING INVESTMENT FUND AND A HOUSING PROVIDER WILL DETERMINE THE POTENTIAL FOR LONG-TERM POSITIVE IMPACT

Housing investment funds represent the supply side of capital. Demand for finance comes from RPs and other housing providers looking for funding to deliver their business targets and growth plans. When considering the potential for impact, an important starting point is the perspective of the housing provider and whether the terms and conditions of the funding are a good match for their financial model and aligned with delivering positive social and environmental outcomes. If the housing provider enters into investment agreements where their obligations to the investor are mismatched with revenues, it can lead to financial pressures, threatening the viability of the housing provider and affecting outcomes for residents as service provision is squeezed (this is true for all debt investors as well as equity investors).

Such inappropriate funding arrangements have happened, particularly in the specialised supported housing (SSH) sector and created significant market concerns to the point that in April 2019 the Regulator for Social Housing (RSH) issued an addendum to their sector risk profile focused on lease-based providers of SSH. This highlighted five recurring themes which the RSH has observed:

- The concentration risk that comes from having long-term, low-margin inflation linked leases as a single source of finance.
- The thin capitalisation of some of the RPs undertaking this model.
- Poor risk management and contingency planning undertaken by some of the RPs.
- Some inappropriate governance practises that have led to poor decision making.
- A lack of assurance about whether appropriate rents are being charged.[7]

DIFFERENT INVESTMENT MODELS WILL HAVE DIFFERENT APPROACHES TOWARD FINANCIAL AND IMPACT RISK

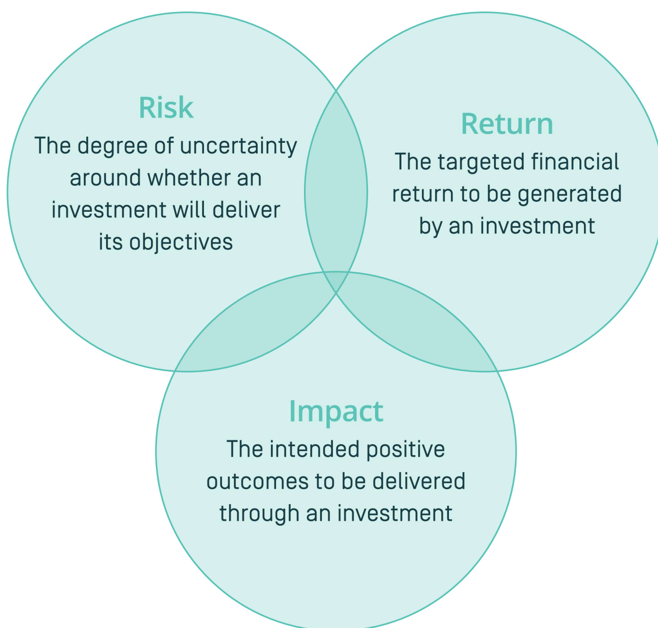
Housing investment funds use a range of different investment models. While designing a common approach to impact reporting for equity investment funds, it was clear that alongside a set of industry-accepted metrics, there was also a need to recognise the link between financing terms and conditions and impact creation.

This paper puts forward a framework to describe the range of investment models from a risk, return and impact perspective. The aim is to help build shared market knowledge and understanding so as to enhance the alignment between financial investment and impact creation in ways that ensure this financing makes a positive contribution to strengthening the sustainability, resilience and impact creation of the social housing sector and mitigates the risks of negative impacts for residents and the social housing sector as a whole.

4. https://www.bbc.co.uk/news/health-48369500.
5. https://www.ft.com/content/5ba2bd52-0250-486b-8a2d-23ccce4977e1.
6. https://www.insidehousing.co.uk/news/hard-to-see-how-equity-linked-associations-can-comply-says-regulator-60908.
7. https://www.gov.uk/government/publications/lease-based-providers-of-specialist-supported-housing.

2. INVESTMENT MODELS: A RISK, RETURN, IMPACT FRAMEWORK

Impact investing brings a third dimension – impact – to traditional investment considerations of financial risk and return. Both BSC and TGE recognise that financing terms and impact creation are intimately linked. The investment model – the financial and legal structure of an investment – will determine not only the financial returns, and level of financial risk borne by different parties, but can also affect how much positive impact is enabled, and the risks of negative impact. All three elements (risk, return and impact) need to be considered when evaluating an investment model. This section proposes a framework to identify and evaluate risk, return and impact considerations.



AIMS OF THE INVESTMENT MODEL FRAMEWORK

There are a range of equity investment models in the social and affordable housing market. The purpose of this descriptive framework is to help differentiate models, recognising that this is an area of financial innovation and new models will emerge. This descriptive framework aims to help bring greater transparency to the market by:

- Enabling housing investment managers to describe their investment model in a clear way and be transparent about their approach to Risk, Return and Impact.
- Supporting housing partners to increase their understanding of the different funding models available, the considerations to be taken into account and the questions to ask when assessing which funding option and providers are best suited to their business model and growth strategy.
- Helping asset owners compare and contrast different housing investment funds and assess their impact thesis, as well as potential negative impact risks and how these are mitigated.

DEFINING EQUITY INVESTMENTS

Equity investments is the broad term we have used to describe all investments where the housing unit is owned by the investor. This could be done by direct ownership, for example where the investment vehicle (such as a fund or Real Estate Investment Trust (REIT)) owns the homes and contracts with a housing management company to manage the property. Or through indirect ownership, for example where the fund establishes or acquires a for-profit registered provider (FPRP) and the investor has equity in the FPRP.

Housing management can then either be outsourced to another registered provider or provided by the FPRP, should they seek to build that capability. Equity investments into joint ventures between, for example, a developer and a Housing Association or local authority are another possible route.

The nature of ownership raises questions as to the nature of the relationship between the landlord (property owner) and leaseholder and what happens when the investor wants to exit and sell the property. There are also critiques that ownership of property by investors is purely driven by profit motives and negative for the sector. This framework aims to look beyond this critique to understand more deeply the nature of the relationship between equity investors and investees through a three-dimensional risk-return-impact lens.

INVESTMENT MODELS – DESCRIPTIVE FRAMEWORK

Beyond ownership, the descriptive framework is based on two broad dimensions that can be used to categorise investment models:

- **Contribution** – How active and directly engaged is the housing investment fund in the quality of homes, customer service and contribution to impact? What is their involvement in the scheme design and housing management? How are they adding value that enables the housing provider to deliver greater impact?
- **Risk and Return** – Which risks is the investor managing and which are borne by partners, or otherwise mitigated? Do the potential financial returns align with this level of risk? Are risks and returns shared fairly?

Put in simple terms, understanding the model helps answer the question: what value does the investor bring to the table, and does this justify the returns they generate?

Impact investing brings a third dimension – impact – to traditional investment considerations of financial risk and return.

1. CONTRIBUTION

The Impact Management Project (IMP) has defined four different strategies which an investor might use to contribute towards impact:

- **Signal that measurable impact matters** – Factoring in the impact that an investment would have as part of the investment process, signaling that impact should be 'priced in'.
- **Engage actively** – Using their expertise, networks and influence to increase the impact of their investments.
- **Grow new or undersupplied capital markets** – Anchoring or participating in new or previously overlooked opportunities.
- **Provide flexible capital** – provide flexibility on achieving risk-adjusted financial return.

Investors should be able to explain their contribution in relation to these different strategies.[8]

SIGNAL THAT MEASURABLE IMPACT MATTERS

For the housing investment fund to signal that impact matters, they would need to show their values and objectives – both business and impact – align with their investee housing organisations, possibly by publishing an Impact Performance Report. It is also expected that these housing investment managers would prioritise higher impact schemes in their investment decision-making. This will in turn make it easier to for housing partners to raise capital for higher-impact schemes. An example of a housing investment fund that signals that impact matters would be a fund that acquires existing properties and acts as a passive landlord. But alone, it is not likely to advance progress on addressing housing need when compared to other forms of contribution.

ENGAGE ACTIVELY

An active engagement strategy is one in which the investor uses its networks and expertise to improve the social or environmental performance of the performance of the housing investment opportunity. From interviews with housing investment funds, housing partners and other sector specialists, the following areas describe the broad set of activities where investors can make a contribution:

ACTIVITY AREA	DESCRIPTION
Investment Design	All activities involved in developing the investment strategy, raising capital and structuring specific financial investments, i.e. the commercial terms and lease arrangements.
Scheme Design and Delivery	Identifying a housing solution to meet a specific need, land sourcing and acquisition, development or acquisition opportunities and forming partnerships with all necessary stakeholders. Ensuring that homes are high quality and have been designed to maximise residents' wellbeing.
Housing Management	The maintenance and ongoing repair work of the homes. Managing rent collection. Listening to and being responsive to the needs of tenants, including the provision of any resident support services.

8. See Impact Management Project, Investor Contribution in Public and Private Markets, Discussion Document.
Photo source: Peabody.

Within these areas, where a housing investment fund manager is able to bring their network and expertise to play a more active role will increase their contribution to the overall impact, particularly if this is an area where the housing partner has more limited capacity or experience.

GROW NEW OR UNDERSUPPLIED CAPITAL MARKETS

This refers to investing in new or previously overlooked opportunities, in which some perceive risk to be disproportionate to return. Equity investment into social and affordable housing is effectively growing an undersupplied capital market, as previously equity investment has focused on investing in the private rental sector and luxury end of the housing market. As the market develops, investors will need to seek out new overlooked opportunities to further push the investment frontier and grow new underserved markets. This could include investments in housing for groups of people with specific needs. For example, the Women in Safe Homes fund, managed by Resonance and with Big Society Capital anchor investment, invests in housing for women who are experiencing or at risk of experiencing homelessness often because they are fleeing domestic abuse. This is a highly underserved area where equity investment could make a positive contribution, alongside public investment and grant funding.

PROVIDE FLEXIBLE CAPITAL

For a housing investment fund to provide flexible capital, they would need to demonstrate a willingness to lower risk-adjusted terms in order to achieve higher impact.

"**Provide flexible capital**" is the concessionary subset of "**grow new or undersupplied capital markets**", while both are a subset of "**signal that impact matters**". "**Engage actively**" can be deployed alongside any of the other three strategies. Investors express a consensus that these strategies describe roles that investors may choose to play in the market, depending on their financial and impact goals, opportunities and constraints. For instance, while all investors can "signal that impact matters" and many can "engage actively," not all can "grow new or undersupplied capital markets" or "provide flexible capital," nor should all be expected to. For this reason, the investor contribution strategies are put forward in a descriptive rather than hierarchical or normative manner.

See page 16 for an example of how a fund could describe their own Contribution, using this framework.

2. RISK AND RETURN

The essence of all investment is putting capital at risk for the potential to generate some level of return. The descriptive framework seeks to understand how housing investment funds are managing Risk and Return with their partners. To deliver the best outcomes, there must be alignment between the housing investment fund and their housing partner investees. We also believe there needs to be a long-term, patient investment approach.

There are a range of risks inherent in the design, development and management of affordable housing. When external investors get involved, it is crucial that these risks are well understood and managed appropriately between the housing investment fund, their housing partners and any external parties. Furthermore, the additional risks that the financing itself introduces need to be considered, since how financing is structured can have a significant effect on both positive and negative impact creation.

While agreeing the terms of investments, a housing investment fund and their investee (often a housing partner) will need to consider a number of factors:

- What is the housing partner looking to use external investment for, and what level of financial returns can this support, over what time period? How volatile or uncertain are these returns?
- What other investment options does the housing partner have?
- What are the underlying investors in the fund looking for? What is their risk and return appetite? How long-term is their interest?
- What risks can the housing investment fund manage and mitigate, given a combination of asset owner risk appetite and fund manager skills and risk management capabilities?
- What risks are housing partners best able to manage? Which do they have capacity to absorb, given their financial circumstances?
- What additional risks to the housing partner and the people they support might result from this investment?

There are many ways to balance these factors - we are not aiming to define 'good' and 'bad' levels of risk and return, however it is important that the terms are a good match and fair for all parties so they can achieve their respective objectives without taking inappropriate risks or resulting in leakage of financial value or excessive profiteering. Housing partners and housing investment funds alike should be fairly rewarded for the risks they take as well as the skills they bring.

RISK THEMES

In our descriptive framework for Risk and Return we have grouped risks into five broad areas. We have put at the centre of this framework the extent of sharing of risks between the parties in an investment (whether through leases or other investment terms). This is in part because a characteristic of equity-like finance is that it generally participates in greater risks than debt, hence its higher returns. But it is also because it is so central to both the positive and negative impact that can result from an investment.

There are two ways that this concept of risk sharing matters:

1 **Inappropriate sharing of risk and return**
Where one party takes all the risk, for less of the return, or where the structures expose one party to risks they are ill equipped to manage or absorb, it will at best hinder impact achievement and at worst, cause negative impact.

2 **Taking on additional risk to achieve more impact**
By participating in the risks inherent in housing development and delivery, a housing investment fund can actually help their housing partner to achieve more impact – for example, where the housing partner may have been constrained by their ability to take on more development risk or more debt finance.

Description of Risks that are shared between the Housing Investment Fund and their partners

RISK AREAS	DESCRIPTION
Planning / development risk	Risks involved in the upfront construction and development phase of an investment. This includes risks involved in the planning process and issues that result in delays to the project.
Political and Regulation risk	Risks related to a change in housing regulation, e.g. risks associated with fire remediation and net zero carbon risk.
Rent policy risk	Risks related to changes in housing benefits policy and wider rent policy. Including freezes to housing benefits.
Repair risk	Risks related to the reactive maintenance, cyclical replacements, and major repairs of the buildings.
Void risk	Risks associated with void homes, caused by delays in people moving in as well as homes that cannot be filled as there is no demand for them. Voids may also occur due to evictions.
Sales risk (where relevant)	For shared ownership schemes, which party takes the risks on poor initial sales.

Within each risk area there is a spectrum of risk sharing and return sharing between the housing investment fund and their partners.

This descriptive framework enables housing investment funds to articulate where they fit on the spectrum for each type of risk and therefore, what they offer to a housing partner, as well as how they manage risks for their own investors.

Spectrum of risk sharing

	RISK TAKEN BY THE FUND AND INVESTORS		RISK TAKEN BY PARTNERS
Planning / development risk	Funding the development of new homes that wouldn't otherwise have been built. including development risk (e.g. new land-led development).	⟷	Fund aims to minimise risk and takes no development or planning risk. Only buying homes that are already built.
Political and Regulation risk	Fund accepts the risk of government policy change (e.g. paying fire remediation costs).	⟷	Housing partner takes on all risks of change in regulation.
Rent policy risk	Fund take on risk of rest policy change (eg. freezing housing benefits, or change to inflation linkage).	⟷	Housing partner bears all risks of policy change, (e.g. rent increases to fund are set at CPI +1% with no flexibility).
Repair risk	Fund takes on all repair risk (e.g. bearing all cost of unexpected repairs).	⟷	FRI contracts are agreed with all housing partners.
Void risk	Fund takes on all risk of voids, through direct tenancies, management agreements or flexible leases to housing providers.	⟷	Housing partners take all void risks, with very limited initial allowances or ability to break.
Sales risk (where relevant)	Fund takes on all sales risk.	⟷	Housing partners take all risks associated with slow sales.

In additional to the risk sharing, how the financial returns[9] are shared must also be appropriate and compensate when one party is taking additional risks.

Financial Returns	Profit margin is all taken by the fund and investors.	⟷	Partners are able to make an appropriate surplus.

9. By Financial Returns, we mean the surplus that remains from rent after the costs of voids, servicing and repairs are covered. Although many RPs are charitable, they do operate as social enterprises and need to have a surplus-generating business model to survive and grow.

Photo source: Peabody.

USING THE DESCRIPTIVE FRAMEWORK

The example below demonstrates how the descriptive framework can be used to describe a fictional fund:

EXAMPLE FUND 1

An affordable, general needs housing fund is acquiring new affordable housing, delivered by a private housing developer through a Section 106 commitment, and is leasing it to an established housing association on a 25-year Full Repairing and Insuring (FRI) lease. Rent increases are set at CPI or the increase in the local housing allowance – whichever is smaller. The housing association took on this finance to grow their services and to generate surplus that they could use to further support their mission, for example, reinvesting the capital in developing new affordable homes or carrying out environmental improvements.

CONTRIBUTION

Signaling that measurable impact matters – The fund has articulated its impact objective: aiming to deliver more general needs affordable housing. By leasing the scheme to the housing association, they are able to expand their service provision.

Actively engaging – The fund is actively engaging in the investment design, ensuring that their lease is structured so that Housing Associations can provide long-term support for residents. The fund is also deliberate in ensuring that they take on any policy risk relating to a change in housing allowance. They are passively engaged with specific scheme design and housing management, as they do not believe they are the experts.

Grow new or undersupplied capital markets – Assuming that there is healthy demand for the Section 106 opportunity, as is often the case, the investor would not be growing a new or undersupplied capital market and is not enabling more (additional) projects to be financed than would otherwise be the case.

Providing flexible capital – Their investments are not providing flexible capital because the fund is still aiming to deliver a commercial risk-adjusted return.

RISK AND RETURN

- **Planning and Development Risk**: Risk is taken by the developer – none of the risk is taken on by the housing association or by the housing investment fund. The housing association has no exposure to cost overruns as the lease only starts when they take on management on the homes.
- **Political and Regulation Risk**: Compliance changes (e.g. Fire Safety policy changes and net-zero risks) are taken on by the housing association – they must take on the costs of all remediation.
- **Rent Policy Risk**: Risk of a significant change in housing benefits (including the risk that rents are no longer CPI linked) is taken by the fund. Rents within the portfolio are mostly set at 80% of private market rent, and rise with CPI as long as local housing allowance continues to rise with CPI.
- **Repair Risk**: The cost of repairs have been modelled upfront and an agreed amount is deducted from the rent paid by the housing association to reflect this. The risk of costs in excess of this modelled amount is being taken on by the housing association.
- **Void Risk**: Risk is taken on by the Housing Association.
- **Sales Risk**: N/A
- **Expected Returns**: The Housing Association is aiming to make a surplus, based on an assumption around voids and repair costs.

HOW THIS CONTRIBUTES TO IMPACT (POSITIVE AND NEGATIVE)

- **Positive impact potential**: Increased supply of homes accessible to those unable to rent or buy on the open market; Provider surplus provides revenue cushion to ensure quality services; Long lease provides the conditions for greater tenancy security and community building and cohesion.
- **Negative impact risks**: By acquiring Section 106 properties the fund may be reducing the opportunities for not-for-profit RPs to grow their portfolios; Homes don't meet high quality building or space standards; Homes are not truly affordable to local median earners or those on lower incomes given the way rent is set in the lease.

CONSIDERATIONS FOR THE HOUSING PARTNER

Fund structure, likelihood and impact of the investor needing to sell the asset; Alignment of interests with investor on scheme design and sustainability; Resilience of margin in the face of downside scenarios on costs (regulation, repairs, voids etc).

EXAMPLE FUND 2

A general needs housing fund that owns a For-Profit Registered Provider (FPRP) is using a Homes England grant to develop new affordable housing. These homes are then managed by a large homelessness charity and let to local authority as affordable temporary accommodation. Rent and rent increases are fixed at the local housing allowance and covered in full by local authority housing benefit.

CONTRIBUTION

Signaling that measurable impact matters – The fund has articulated its impact objective, which is to increase the supply of high-quality temporary accommodation, and is only selecting assets that meet the impact criteria.

Actively engaging – The fund is actively engaging on the investment design and the scheme design. They are working closely with their charity partner to design new schemes that meet a local need. They are managing the charity partner via a service level agreement (SLA) – enabling them to closely support them and ensure they provide a high-quality service.

Grow new or undersupplied capital markets – There is a significant shortage of high-quality temporary accommodation and the fund is using its own capital, as well as a Homes England grant to bring new homes into this market that wouldn't otherwise have been turned into affordable housing.

Providing flexible capital – Their investments are not providing flexible capital, because a lower level of return is not expected due to the impact. However, there is some acceptance of higher risk than is typical in the market, without a commensurately higher return.

RISK AND RETURN

- **Planning and Development Risk**: The fund is taking on development risk, and no risk is being passed onto the homeless charity.
- **Political and Regulation Risk**: Compliance changes (e.g. Fire Safety policy changes and net-zero risks) are taken on by the fund, via their FPRP.
- **Rent Policy Risk**: Risk of a significant change in housing benefits (including the risk that housing benefits don't grow with inflation) is taken by the fund.
- **Repair Risk**: Reactive Repair Risk is taken on by the homeless charity, however all cyclical replacement risk, and long-term repair risk is taken by the fund.
- **Void Risk**: Risk is taken on by the Local Authority (who have a nominations agreement).
- **Sales Risk**: N/A
- **Expected Returns**: The homeless charity is able to make an appropriate surplus, given their risk-profile.

HOW THIS CONTRIBUTES TO IMPACT (POSITIVE AND NEGATIVE)

- **Positive impact potential**: Unlocking investment AND grant to increase the supply of temporary accommodation providing an alternative to street homelessness and other unsafe and more insecure alternatives; Genuine affordability to tenants as housing benefit covers 100% of rent; Access to additional support and services from charity partner, such as mental health or employment support.
- **Negative impact risks**: Insecure tenancies if provided on license rather than assured tenancy agreements; Insufficient revenue funding to charity partner under SLA to provide necessary support to high needs tenants; Properties don't meet space standards; Inaccessible school and transport options for working families.

CONSIDERATIONS OF THE LOCAL AUTHORITY

Rent setting; Fund structure and likelihood and impact of the investor needing to sell the asset; Quality and robustness of the SLA and accountability in the event of failure in duty of care; Governance and capabilities of the FPRP in executing effective building management.

FINAL REFLECTIONS

We believe that creating a descriptive framework for describing the Contribution and Risk & Return of housing investment funds will promote transparency and stakeholder accountability across the market. Asset owners will be able to deepen understanding of the models and compare potential funds, and housing partners will be able to ask the right questions of potential investors to ensure the investment meets their needs. Transparency will also increase standards as housing investment funds start to compete and benchmark themselves on impact performance, not just financial performance.

WE WELCOME FEEDBACK AND COMMENTS ON THIS FRAMEWORK

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Transparency will also increase standards as housing investment funds start to compete and benchmark themselves on impact performance, not just financial performance.

Photo sources: page 18, top left and bottom from Civitas Investment Management, top right from Triple Point, and back cover from Triple Point.

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