Residential Secure Income

Update
04 December 2019

RESI is targeting a 5% inflation-linked yield...

Summary

Residential Secure Income (RESI) is a real estate investment trust (REIT) that invests in the social housing sector, aiming to generate an RPI-linked 5% dividend yield and 8% total returns per annum.

RESI takes a cautious approach to selecting assets, which requires the ability to raise debt equivalent to investment grade against each proposal. RESI has a target gearing level of 50% of GAV. Investments have so far been focused on the retirement homes sub-sector and shared ownership sector, with other investments made in local authority housing. Importantly, it is worth noting that RESI has no exposure to the specialist supported-housing sub-sector, which has been the focus of regulatory attention thanks to the weak balance sheets of some housing associations (HAs) in this sub-sector.

RESI is now close to being fully-invested, having invested £300m of a targeted £340m, split 50/50 between debt and equity. Deployment was initially slower than expected, but recent deals in the shared ownership sector have brought RESI close to fully invested and created a more diversified portfolio.

RESI pays quarterly dividends and has declared aggregate dividends of 5p for 2019, in line with its target, which the managers aim to increase broadly in line with inflation and represents a yield of 5.5%. The dividend is not yet covered by rental income from the portfolio (although it is covered from total earnings). However, the manager projects full rental cover to be achieved by the end of 2020 as the shared ownership portfolio becomes income producing.

The shares currently trade on a discount of 12.5%. While this is wide in absolute terms, it is tighter than RESI's social housing peers, which have seen their discounts move out markedly following the Regulator of Social Housing announcing it was investigating the business models in the specialist supported housing sector they invest in (and RESI does not).

RESI is managed by a team at RESI Capital Management Limited, a subsidiary of TradeRisks, which has been a specialist treasury adviser and debt arranger to the social housing and broader social infrastructure sector for 18 years.

Analyst's View

RESI is now close to being fully invested. While it was disappointing that deals fell through in 2018 and it has taken more time to get to this point than intended, we believe the benefits of the cautious diligent approach can now be seen. RESI's two peers in the social housing sector are dealing with the potential fallout of investing in a sub-sector with riskier balance sheets, while RESI is raising debt equivalent to investment grade against its assets in areas of no concern to the regulator.

Key Information:

As at	27/11/19
Price (p)	95
Discount (%)	-12.5
OCF (%)	1.55
Yield (%)	5.3
Gearing (%)	27
Ticker	RESI
Turnover Ratio (%)	0.5
Shares (£)	179,485,949
Market cap (£)	170,511,652

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As a result, we believe that RESI deserves the tighter discount rating than its peers that it currently enjoys. A 5% inflation-linked dividend from investment grade assets is an attractive proposition for many, we believe, so once RESI is fully invested and generating this income from its portfolio, there is no real reason for the wide discount to remain. In our view, therefore, once the dividend is fully covered by income, or imminently so – projected to be by the end of 2020 by the manager – this should see the shares trade much closer to NAV.

Analyst's View

BULL	BEAR
A 5% inflation-linked prospective yield is highly attractive	Full dividend coverage depends on RESI making remaining investments in line with its business plan
The high level of demand for social housing should support future investment opportunities	A hard-left government might seek to restrict further private sector investment in the sector
The management company has extensive specialist experience in social housing in every function	Relatively high gearing – target level of 50% on LTV basis or 100% on NAV basis

Portfolio

Residential Secure Income (RESI) invests in the social housing sector, or more specifically the affordable shared ownership, retirement and local authority housing sub-sectors, targeting a low-risk 5% inflation-linked dividend yield as a part of total returns of 8% a year.

RESI aims to make a meaningful contribution to alleviating the UK housing shortage by meeting demand from housing developers (HAs, local authorities and private developers) for long-term investment partners to accelerate the development of socially and economically beneficial, new and affordable housing. RESI offers investors a way to fund the provision of accommodation to the less well-off and earn an income in the process. As the table below illustrates, there are many different aspects or sub-sectors within social housing. RESI focuses on shared ownership and the retirement sector, with other investments in temporary housing for local authorities.

RESI was launched in July 2017 after raising £180m of equity, and aims to leverage its property investments to 50% on an LTV basis by issuing debt against those properties. RESI has now invested £300m in a portfolio that is now valued at £321m thanks to valuation uplifts, with the current sector breakdown of the portfolio below.

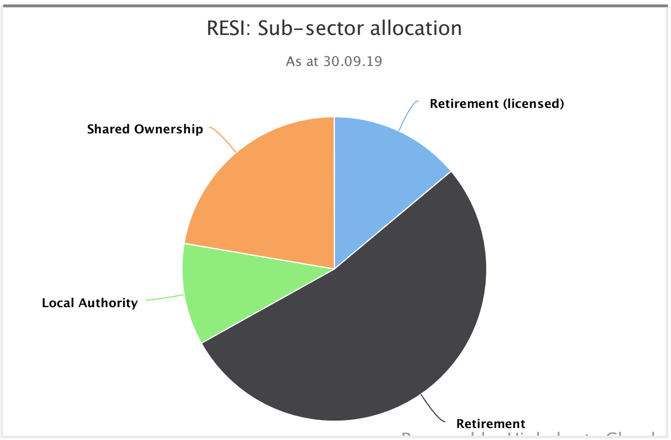
RESI is currently 67% invested in retirement properties that, once RESI is fully invested, will comprise around half of the portfolio. The most recent purchases were investments of £77m in the shared ownership sector. The manager, Ben Fry, tells us RESI is focusing its efforts on that sector for its remaining purchases. The allocation is currently 22% in shared ownership, with the remaining 10.8% of the portfolio in local authority housing.

The Social Housing Sector

	SHARED OWNERSHIP	RENTAL HOUSING		
Sub-sectors		Market rent	Functional	Sub-market rent
Focus for RESI	Shared ownership housing.	Local authority housing.	Retirement rental.	Affordable and intermediate housing.
Purpose of asset class	Allow first time buyers to get on to the property ladder.	Provides accommodation for those otherwise in temporary or emergency accommodation.	Provides a rental option with lifetime security of tenure for the elderly or those requiring specially adapted homes.	Subsidised rent for key workers and low income groups.
Benefits to RESI and investors	Long-term (130 year) inflation-linked (RPI + 0.5%) leases with shared owner option to staircase (i.e. purchase a bigger share in the property at the then market value), crystallising valuation growth for RESI.	Leases are direct with local authorities that are generally AA rated entities and have a statutory duty to house those who are homeless or threatened with homelessness. RESI rents around market rent to minimise downside risk if the local authority doesn't renew the lease.	Rental payments are de-linked to the economy as tenants pay through pensions, housing benefits etc. The asset class also includes property used to house property managers, with rent ultimately paid through by the service charge of other residents.	High demand due to a shortage of other affordable housing options.

Source: RESI Capital Management

Fig.1: Sub Sector Exposure



Source: RESI Capital Management

Ben tells us that the pipeline of potential investments is strong, as the social housing sector is in need of capital. RESI turns down three of every four opportunities it considers, and has no shortage of opportunities for the remaining investment. The cautious, safety-first approach to investment is one reason that the initial deployment of its initial public offering (IPO) proceeds, was slower than anticipated. The sum was invested within 12 months, however, and the pace of investment has since accelerated and RESI is now close to being fully invested at its target gearing level of 50% of gross asset value (GAV). Ben estimates that he has turned down over £3bn in potential deals as they did not meet his stringent criteria. RESI ensures that all the assets it purchases can be used to raise investment grade debt, which reduces the rate it has to pay on its borrowings, but also reflects the lower credit risk of RESI's ultimate counterparties. This contrasts with the approach taken by the two peers, both of which have run into difficulties by leasing properties to small HAs who the regulator has found to be poor credit risks.

As we note above, Ben concentrates on what he considers the lower-risk projects in the sector. He does this by investing in accordance with three themes: (1) properties with 'sticky tenants'; (2) properties where the tenants pay below market rent; and (3) those which are leased to a local authority or another body with a statutory duty to provide housing.

'Sticky tenants' include the retired, who are typically reluctant or unable to move, key workers such as nurses who need to be housed near to their place of work, or 'live-in' housing managers for such projects. As these groups are unlikely to move, the rental income stream is more secure. This explains the appeal of retirement properties, for example, which also benefit from the fact that the rent is backed by the pensions of the residents rather than by more variable or shorter-term sources.

Shared ownership structures also have a number of features that sit well with the investment approach of the manager. In these schemes, shared owners put down a small deposit and mortgage the remainder of a certain proportion of the total property value, typically a 25% initial share. The remainder is owned by the HA or investor, and the shared owner pays an inflation-linked rent on it, typically RPI (growth in the retail price index) plus 0.5%. The investor, such as RESI, buys its share below market value from the developer, and then over time the shared owner purchases further incremental interests in its property at the then market level, which for RESI results in an uplift in the value of its investment.

'Local authority housing' refers to properties leased by local authorities to house tenants in immediate need of short-term accommodation. For example, RESI owns properties in Luton, which Luton Borough Council uses to house those who are homeless or at risk of homelessness. Such accommodation is a more preferable solution to councils than putting people up in hotels or B&Bs (as well as being a far better living situation for the tenants). RESI has bought two properties in Luton that yield 5%. Ben hopes to do more deals in this sector but notes that although there is long-term demand from local authorities for this type of accommodation, it is hard to get the councils to agree to leases over ten years, as this impacts the funding they receive. In the retirement and shared ownership sub-sectors, the deals are much longer, typically backed by assured tenancy agreements providing lifetime security of tenure for retirement rental homes or long-term shared ownership leases.

RESI had originally expected to invest its IPO proceeds by April 2018, but three deals worth £250m in the shared ownership sector fell through at an advanced stage due to changes in strategy of management on the vendor side. It has taken time to find suitable alternative investments, thanks to the high levels of security the manager requires. While this is obviously disappointing for shareholders, we believe it is a positive in the long-term as RESI's investment criteria are maintained.

RESI has taken an innovative step to fill its pipeline of potential investments. In July 2018, authorisation was granted to a wholly-owned subsidiary, RESI Housing, to operate as a for-profit registered provider of social housing.

RESI Housing allows RESI to purchase properties and repurpose them for social housing needs (such as shared ownership) with the support of government grant funding. In October 2018, the company announced the completion of its first such deal. The RESI group bought 34 new-build homes in Barnet from Crest Nicholson for £16.45m.

The properties will be sold as shared ownership homes, aimed at first time buyers with small deposits. In March 2019, the RESI group spent £60m on a second tranche of shared ownership properties purchased from Metropolitan Thames Valley Housing, one of the UK's largest HAs.

Given the high number of opportunities in the market, we understand future placings are not out of the question once the final investment is made. The RESI board has the authority to issue up to 10% of the share capital as long as it is at a premium to NAV, although the trust currently trades on a significant discount. The fund manager has an identified pipeline of £701m shared ownership homes sourced through off-market industry relationships and a £300m partnership agreement with Morgan Sindall, which targets delivery of 1,500 new shared ownership homes. RESI is also investigating further opportunities in the local authority housing sub-sector.

Peer group

There are two other REITs specialising in social housing investment, but they have very different business models. Both Triple Point and Civitas have concentrated on specialist supported housing. This is adapted accommodation for those with special needs and is let at 1.5-to-two times the market rent, reflecting its scarcity and the work involved to prepare it for use. The benefit of this sub-sector is that the rent is ultimately paid by the state through housing and other benefits, via leases with small HAs. This leads to one of the key drawbacks, however. Rents are so high thanks to the scarcity of stock; should this scarcity cease to be such an issue, rents could be driven down as there is ultimately only one 'customer' in each geographic area, and rental payments follow the underlying resident not the building.

This issue is compounded by letting to small HAs. These HAs therefore don't own the homes themselves, but lease them, and therefore have very low levels of asset backing. They also have much shorter rental contracts with the local authorities than their lease obligations to the investors (such as the investment trusts). This means that if the local authority cuts the rent they will have no recourse, and there are potential risks to solvency from the mismatch between the duration of assets and liabilities. This is a threat to the end user of the accommodation, which is why the regulator is concerned (see Discount section).

RESI has no exposure to the social supported housing sector.

Gearing

The company's strategy is to run with 50% gearing of gross assets when fully invested (i.e. on an LTV basis); this would equate to 100% on an NAV basis. This is achieved by gearing up each transaction by borrowing roughly 50% of the value of a deal secured against specific assets (rather than the portfolio as a whole) with long-term debt that matches the asset's cashflows to minimise interest rate and refinancing risks. The company benefits from TradeRisks' debt investor relationships and experience as a corporate finance specialist in the sector. In line with RESI's pre-condition for any property acquisition, the debt taken on by RESI (but secured on specific assets) must all be assessed as an investment grade.

RESI has so far issued £111.5m of debt. Three of the four debt transactions so far have been long-term (25 year) fixed-rate deals, which reduces the risk it will have to be refinanced at higher costs. The average interest rate is 3.46%, and the loans are partly amortising. The fourth debt deal is the smallest and is partially fixed for three years at 2.56%. With the equity of the company at around £170m (after share buy-backs), there is roughly £50m of gearing to be arranged to reach the desired 50% ratio, once assets are purchased or committed.

Performance

RESI's NAV total returns to 30 September 2019 were 17.3p, or 18% since launch in July 2017. In capital terms, the NAV has risen from 98p at launch, to the current, most recently announced, NAV of 108.6p as at 30 September 2019, representing a gain of 10.8%. As we discuss in the Dividend section, RESI is as yet not paying a dividend covered by the rental income on the portfolio, although it has declared dividends of 3p for 2018 and 5p for 2019.

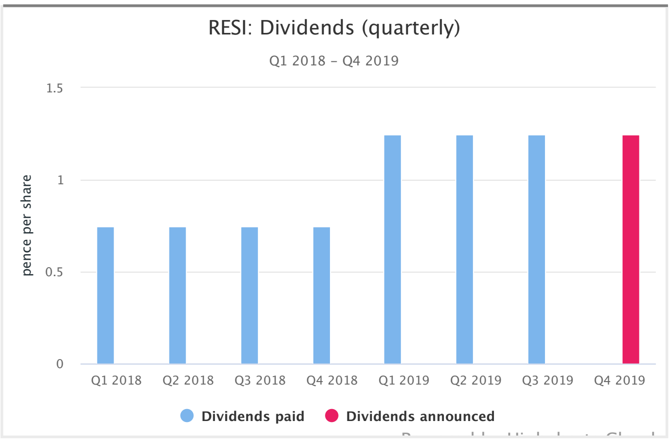
A substantial part of the NAV total returns have so far come from extending the leases of the retirement properties in the portfolio, which increases their present value for accounting purposes. The leases on 1,003 properties were extended from 70 to 150 years in June 2018, and the same was done to 279 properties in March 2019, contributing £1.6m to valuation gains in the year. We understand there are still a small number of leases to be extended, but this enhancement to NAV cannot be repeated.

The other major factor driving total returns has been the inflation-linked income with £6.6m fair value gains during the year attributable to contractual rent increases embedded in the portfolio. As RPI has risen, the company has received higher interest payments from its lessees, and consequently the value of the properties, based on discounted cashflow models, has risen. Because the existing retirement properties are geared with debt that is fixed and not linked to RPI, the equity of RESI has felt roughly double the effect of the RPI rise (based on the 50/50 debt to equity target split, which has not yet quite been achieved). The aim is to have the portfolio fully invested in the coming months, at which point the dividend should be fully covered by the income from the portfolio on an annualised basis, as discussed in the Dividend section, and so will be unaffected by the regulator's judgements.

Dividend

RESI has hit its 5p annual dividend target for the financial year beginning October 2018, delivering four payments of 1.25p. The managers expect this to increase broadly in line with inflation. The prospective yield on the share price is therefore 5.3%. This 5p dividend is up from the 3p targeted and paid in the first financial year, reflecting the fact that the portfolio was being ramped up and was not receiving income on all its assets for the whole period.

Fig.2: Dividend



Source: Morningstar

The managers report that the invested portfolio is delivering an unleveraged net yield in excess of the 5% dividend target. The levered yield on cost of the retirement properties is 6.9%, the local authority properties 7.2% and the shared ownership properties projected at 6.5% (see the table below).

Fig.3: Portfolio Yield

	Retirement	Local Authority	Shared Ownership *(projected)*
Value	£215m	£36m	£72m
LTV	45%	42%	*c. 60%*
Interest cost	3.46%	2.56%	*TBC*
Net yield	4.7%	5.3%	*3.3%*
Levered Yield on cost	6.9%	7.2%	*6-7%*

Source: RESI Capital Management

The weighted average leveraged yield on cost is 7% on the whole portfolio excluding the shared ownership holdings, which are not yet paying a yield and not yet leveraged. Subtracting 1.5% of ongoing charges gives a small cushion over the 5% dividend target. These are all annualised figures, however, and the shared ownership properties have yet to be fully let, so it will take some time for the dividend to be fully covered by the income from the portfolio. Ben forecasts this will happen by the end of 2020, with some investments still to be made and debt raised.

The fixed nature of the debt and the RPI-linked nature of the cashflows produces a favourable dynamic for shareholders. When RPI rises, the company receives the uplift on equity and debt-funded assets, but the funding cost does not change. The equity investor therefore effectively receives double the increase in RPI to their income (gross of any revenue held back in reserve). It is worth bearing in mind that the opposite is also true, and so there are risks (unlikely, but possible) that if we enter into a phase of deflation the negative effects will be amplified for shareholders.

Management

RESI is a REIT that was launched on the London Stock Exchange in July 2017, and is managed by RESI Capital Management Limited, part of the TradeRisks group. TradeRisks is a long-standing actor in the social housing and social infrastructure sector, with 18 years' experience providing and arranging debt. RESI is designed to provide a source of equity funding to the social housing sector, replacing the steadily declining availability of government grants.

Investment manager Ben Fry is an accountant by training who has worked at TradeRisks since 2011. He sits on a four-man investment committee, which is chaired by Jonathan Slater, one of TradeRisks' founders, and includes Mark Rogers, CEO of the new registered social housing provider RESI Housing, and Pete Redman, managing director of property. Behind them is a team of 24 people, not including the investment committee, at TradeRisks/RESI Capital Management, which is led by Alex Pilato, TradeRisks' group chief executive, and former head of JPMorgan's risk advisory business. In our view the specialist experience on the committee and in the wider team is a key selling point of RESI. Both Mark and Pete are former CEOs of major housing providers, while RESI's board of four comprises three members with experience within housing providers or local authorities and one former head of debt capital markets at HSBC and at JPMorgan. This is a relatively young market and RESI is managed by a team with comprehensive experience of all its facets.

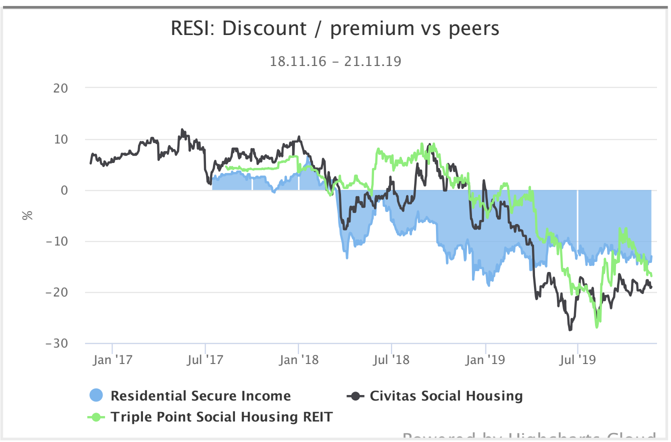
Discount

As the graph below shows, RESI fell from a premium (achieved for six months following launch) onto a discount of around 10% in the first quarter of 2018. This can largely be attributed to the postponement of three shared ownership deals, which left the company holding cash. In our view, this knocked investors' confidence. However, as discussed above, RESI is now almost fully invested and has made significant purchases in the shared ownership subsector. Furthermore, it is now paying a quarterly dividend in line with its 5p annualised forecasts, although we note that the dividend is not yet covered by rental income.

RESI's discount to NAV of 12.5% has held up relative to its peers in recent months, as the latter have seen their discounts widen sharply. The Regulator of Social Housing has been investigating the small HAs to which it leases its properties following the failure of one, First Priority, and has found a number to be non-compliant financially and the model potentially unviable in the long-term. In its April report, the Regulator of Social Housing stated that it would be working with the boards of the regulated providers to attempt to strengthen their business model and improve their governance. However, it warned that if it could not find a way to return the organisations to compliance, then all options were on the table and creditors and investors could suffer losses.

RESI's discount is tighter than its peers, we believe, as the market now recognises that the regulatory judgements made against lessees of Triple Point and Civitas do not affect it, as it has no exposure to the troubled supported specialist social housing model. Previously, RESI's discount tended to widen along with these peers following the regulatory judgements, which in our view was thanks to a misunderstanding by the market that all three companies faced similar risks.

Fig.4: Discount



Source: Morningstar

We believe the current tighter rating for RESI is justified by the more defensive income stream and lower regulatory risk. However, we think it is likely that the discount will remain until the dividend is fully covered by rental income or it becomes clear that it soon will be, which may not be until late 2020.

RESI implemented a share buyback programme in April 2018 and to the end of November 2018 repurchased 9.3 million shares at an average price of 92.5p, representing 5% of the shares in issue. Buybacks were paused at that point in order to commit the cash to investment opportunities. These purchases at a discount to NAV generated accretion in NAV per share estimated at 0.6p, and are held in treasury. The board states they are not expected to be reissued except at a premium to NAV (in line with the prospectus commitment that future issues to grow the REIT will be at NAV or above).

Charges

RESI's 2019 results show an ongoing charges ratio (OCR) of 1.55%, compared to Triple Point's OCR of 1.92% and Civitas at 1.93%. The managers estimate that at the current level of assets (end of September 2019) the figure should be 1.5% annualised, reflecting the benefits of increasing scale, which the manager expects to be felt as RESI grows. The management fee is 1% on the first £250m of NAV. Should NAV grow above £250m, 0.9% will be charged up to £500m and 0.8% up to £1bn. This is the same tiered set of charges made by Civitas and Triple Point. Of the management fee, 75% is paid in cash and 25% in shares, which aligns the interests of the fund manager and shareholders. The management company and its directors own almost 1.6% of the share capital. There is no performance fee.

ESG

RESI aims to make a meaningful contribution to alleviating the UK housing shortage by meeting demand from housing developers (HAs, local authorities and private developers) for long-term investment partners to accelerate the development of socially and economically beneficial, new and affordable housing. RESI offers investors a way to fund the provision of accommodation to the less well-off and earn an income in the process.

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