For Investment Professionals only

M&G Investments

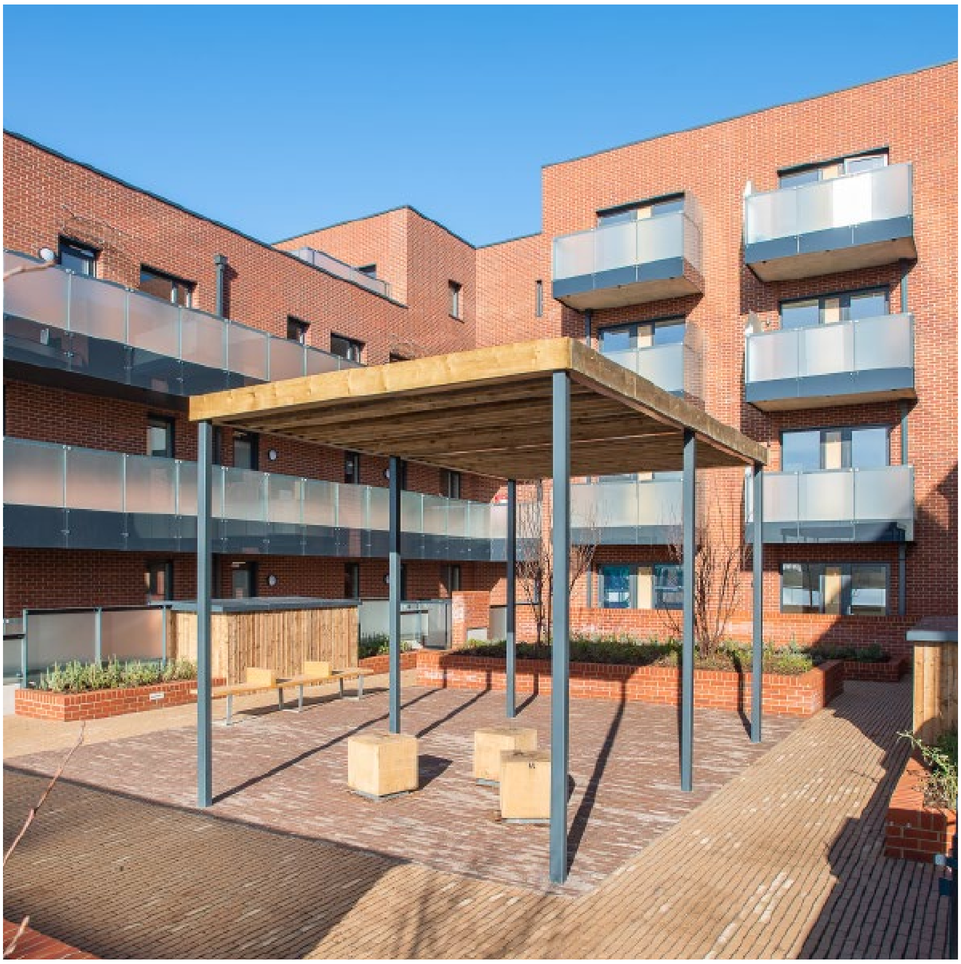
September 2021

Guide to Shared Ownership

Executive summary

- Barriers to home ownership are high, with significant affordability constraints across parts of the UK. As the Private Rented Sector (PRS) grows, along with demand for new, flexible living solutions, Shared Ownership stands to become one of the next mainstream tenures. For occupiers, Shared Ownership provides affordable and sustainable access to the housing market, available to a significant proportion of the UK population.
- For investors, the sector offers an attractive, long-term income stream, delivered with low volatility. In the current economic climate, Shared Ownership provides a particularly defensive investment thanks to the benefit of inflation-linked rents.
- Maintaining ownership of a proportion of a Shared Ownership asset also offers the opportunity to capture house price growth, with the potential for strong capital appreciation over the long term.
- Accessing Shared Ownership adds portfolio diversification due to the low correlation between residential and other asset classes.

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Where past performance is shown, please note this is not a guide to future performance.



This page and front cover: The Hyde Group.

Shared Ownership is a potential solution for aspirational home owners who cannot afford to buy a property outright. The scheme enables a household to buy a share of a new home with (or without) a traditional mortgage and pay a discounted rent on the remaining share.

The sector also provides a defensive alternative for investors looking for long-term, secure, index-linked income and house price exposure, as the investor maintains the unsold equity and benefits from inflation-linked rent on their share of the property.

History

Shared Ownership is a long-standing tenure type, operating since 1979, though delivery has been extremely limited until now, and predominantly fulfilled by housing associations. According to Savills, there are more than 200,000 households living in Shared Ownership, although this still represents less than 1% of total households in England[1].

We are confident that the sector has the potential to grow significantly for several reasons:

- The unaffordability of home ownership provides compelling underlying demand for the sector's expansion.
- Recent government policy intervention has been supportive of Shared Ownership, as policy makers recognise the sector's ability to assist in tackling the UK's affordable housing shortage.
- Investors are increasingly turning to alternative residential sub-sectors to diversify portfolios towards reversionary investments and secure, defensive, long-term indexed-linked income.

What is Shared Ownership?
Shared Ownership is a flexible solution for those aspiring to take a first step onto the housing ladder, where the initial share purchased by the occupier can be as little as 25% and up to 75% of the property value. This share can be bought with (or without) a traditional mortgage.

The investor retains the remaining equity share and also receives rent, typically set at 2.75% of the market value of the retained share. This is set as a guide by the government to ensure rents are at a subsidy to market rents, which facilitates affordability for the occupier when combined with capital repayments on the mortgage element. This rent is inflation-linked. Contracted RPI-linked rental uplifts create growth in the income stream and provide inflation protection. The investor also benefits from any capital value appreciation on their share of the property over time.

Figure 1 An accessible means of home ownership

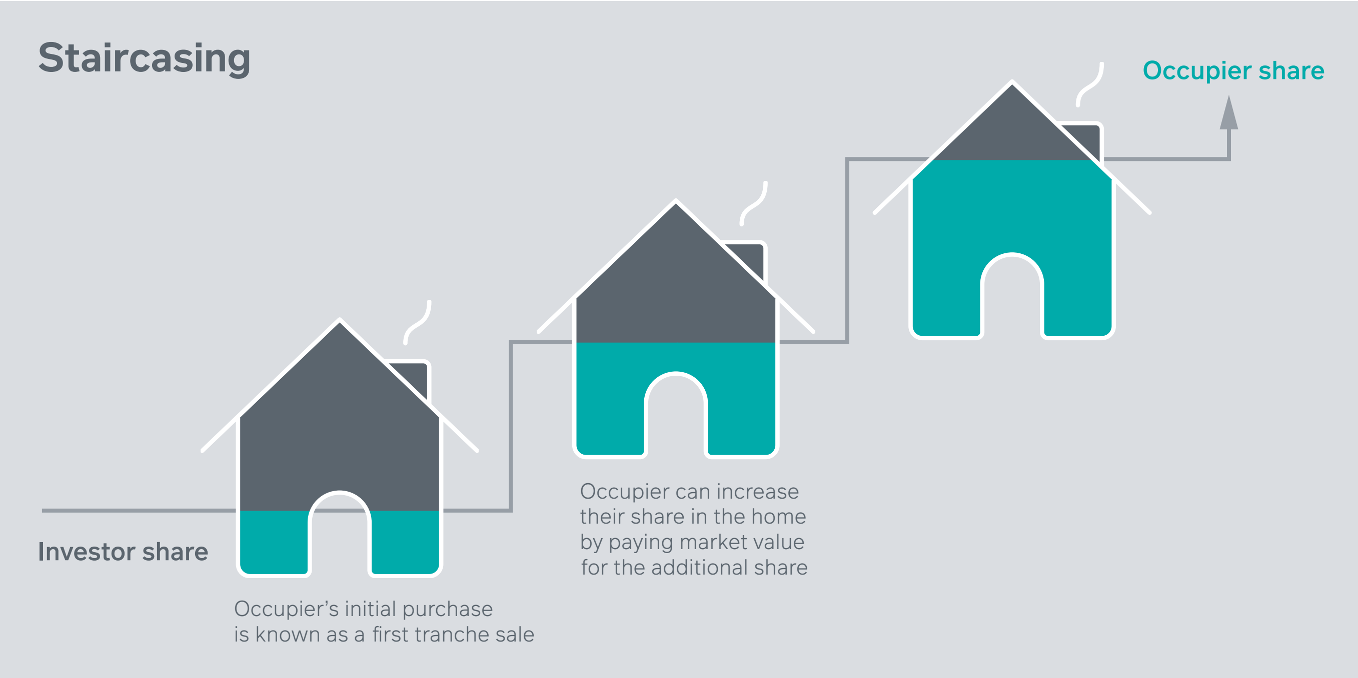
Investor share 75%
Inflation-linked income with house price exposure

Occupier 25%
Affordable step onto the housing ladder, partnering with a stable and secure landlord

Source: M&G illustrative.

[1]Shared ownership, Savills, 2019; English Housing Survey, 2018/19.

Figure 2 Staircasing



Source: M&G illustrative.

Accessible to the UK population

As Shared Ownership is accessible to a much wider proportion of the UK population than outright home ownership, potential occupier demand could boost the growth of the sector to a much larger scale. To qualify, the would-be buyer must have a household income below £90,000 in London and £80,000 in the rest of the UK. This includes a significant proportion of the UK population as gross earnings for the median two-full-time worker household in the UK is only c.£63,000[2]. This income threshold is only tested at the time of purchase, not on an ongoing basis. The scheme is available to households who are privately or socially renting, or even households which have previously owned, but no longer do so.

Staircasing

Occupiers have the option to buy additional shares in the property, up to 100% of its value – known as staircasing. This typically happens in increments of greater than 5%. Staircasing has benefits for the occupier in securing a greater share of the property, but also benefits investors too.

When the occupier staircases, they pay current market value for their new share, as valued by a pre-agreed independent valuer. By realising the value of the sold share of the property, the investor is able to capture any house price growth. This reduces the equity owned by the investor, consequently reducing the portion on which the tenant pays rent.

[2]ASHE 2020, Nomis, February 2021.

In a Shared Ownership portfolio, the degree of staircasing is typically low, averaging at only around 2% per annum. According to National Housing Group (NHG), the average length of time before a shared owner begins staircasing is 4.5 years.

To exit a Shared Ownership home, the occupier can either fully staircase, becoming the legal owner, or they can sell their share of the property at market value. If they wish to sell the property, the occupier is contractually obliged to market the property to other potential shared owners for a pre-agreed period of time, during which the investor has ‘pre-emption rights’. If the property fails to sell to the shared owner market during this period, the whole property can then be sold on the open market. In this scenario, and where a shared owner fully staircases, the investor receives their share of the capital, and benefits from any house price growth.

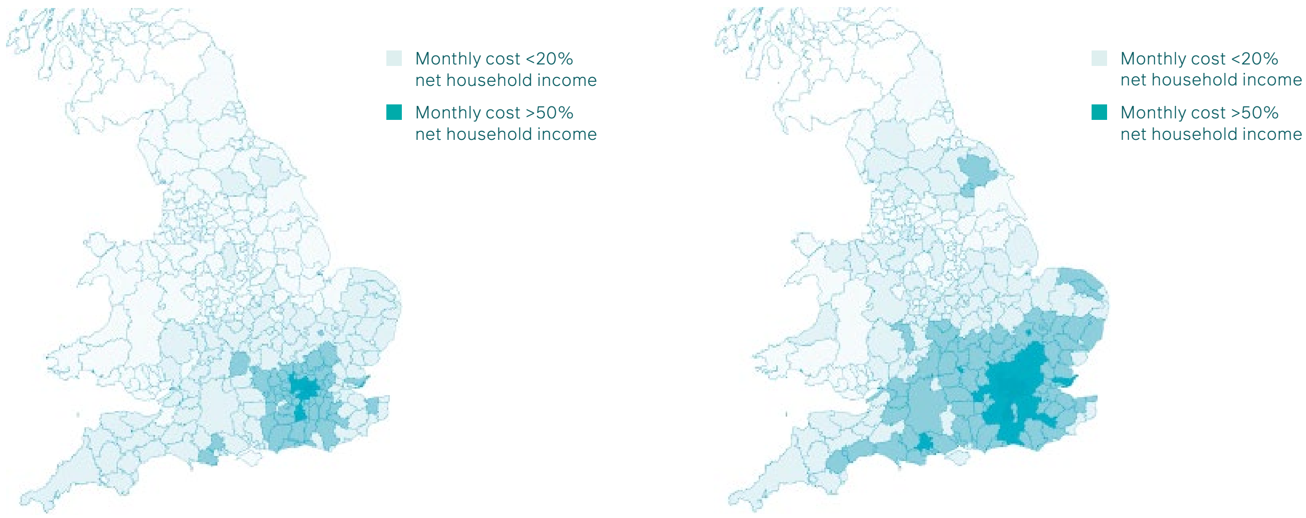
Demand drivers

Demographic trends suggest that the demand for housing will continue to rise as the UK population keeps growing (by 0.4% per annum [2020-2030[3]]) and household size falls. The government is targeting that some 300,000 new homes need to be built in England annually; research from the National Housing Federation suggests an even greater need of c.340,000 homes per annum. However, supply is lagging behind, with only c.150,000 per annum new homes built in the five years to 2020[4]. While, pre-pandemic, new Permitted Development rights had helped to increase supply through change of use, boosting net additions to a more than 20-year high of 244,000 in 2019/20, this still fell short of the target[4]. The resulting long-standing supply and demand imbalance will place further upward pressure on house prices and rental growth over the long run.

Figure 3 Monthly cost as a % of net income

Shared Ownership
SO housing cost as % of lower quartile income

Traditional first-time buyer
FTB housing cost as % of lower quartile income



Note: LTV 90% over 25 years; interest rate 3.6% (first-time buyer) and 4.1% (shared owner)*; median-weighted capital value; lower quartile (LQ) earnings with income multiple of 1.4; 100% first-time buyer purchase; 40% Shared Ownership purchase; rental yield 2.75% on investor’s remaining share. *Interest rates are typically higher for shared owners.

Source: Bank of England, January 2021, Hometrack, January 2021, Nomis, March 2021, Ministry of Housing, Communities and Local Government, March 2021.

[3]ONS, 2020.
[4]Ministry of Housing, Communities and Local Government, March 2021.

Barriers to home ownership are high, mainly due to the need for large housing deposits. This is a significant affordability constraint, particularly in London where the average house costs more than nine times (x) a typical worker's gross earnings, well above the long run house price to earnings (HPE) ratio of 5.7x[5]. The open market provides housing for people that have enough equity, while affordable home ownership products, such as Help to Buy, provide an entry point for first-time buyers in the housing market. However, in areas where housing is acutely expensive, some affordable home ownership products are still inaccessible without financial assistance from the 'Bank of Mum and Dad'. Consequently, almost 40% of private renters and 48% of social renters believe that they will not be able to buy a property for at least five years[6].

The residential market is structurally changing as the Private Rented Sector (PRS) has grown, with 4.4 million households living in private rented accommodation. The PRS now represents c.19% of the English market[6], up from 10% in 2001. Coupled with rising demand for new, flexible living solutions, Shared Ownership, therefore, provides a growing opportunity to satisfy this need.

For the same property, the average monthly cost of Shared Ownership is lower than for a first-time buyer across most of the UK. This is shown by Figure 2 (above), which reflects this cost as a proportion of lower quartile income. In addition, the deposit requirement is also significantly lower. Therefore, Shared Ownership enables households to get a first step onto the housing ladder at a lower cost. Occupiers gain access to house price growth, benefit from higher security of tenancy and secure greater flexibility over ownership at a more affordable level.

Demand for Shared Ownership is potentially substantial and is likely to be greatest where house prices are least affordable. London is an obvious focus for Shared Ownership investors, given the city's acute affordability pressures and strong underlying fundamentals. Large regional cities and areas in the wider South East region, that have transport and employment hubs and similar affordability pressures, also look attractive from an investment perspective.

[5]Nationwide, Q2 2021.
[6]English Housing Survey, 2019-20.

Fulfilling a social need

- **Affordable homes:** providing the means to access the housing market in areas of acute need, for example for groups such as key workers, while increasing the number of affordable homes built
- **Sustainable homes:** providing good quality buildings in close proximity to areas of employment and transport infrastructure
- **Secure homes:** a stable and experienced investor/landlord
- **Accessible homes:** set to become a significant route to affordable home ownership for those unable to access the market

The Shared Ownership sector fulfils a social need, creating stability for lower income households by helping them take part-ownership of where they live.

Shared Ownership is categorised as affordable housing. Occupiers are able to benefit from Stamp Duty Land Tax (SDLT) exemptions on properties up to £500,000. Furthermore, Shared Ownership housing can be delivered through a developer's Section 106*. A developer contribution may require delivery of affordable homes within a residential scheme to make development acceptable.

Market uncertainty underpins the case for Shared Ownership

The sustained impact of the COVID-19 pandemic has permeated all areas of life, alongside the economy. Unlike past economic downturns, the pandemic has resulted in special importance being placed on our homes, as both a refuge and workplace for many. As a result, how and where we live has come into greater focus.

Combined with the government's SDLT holiday, this has led to a surge in activity in the housing market, with house prices rising by more than 10% per annum in July 2021[7].

*Section 106 is a UK planning obligation which stands as a private agreement between local authorities and developers, and can be attached to a planning permission to make developments acceptable.

[7]Nationwide, August 2021.

We anticipate that as the economy and labour markets continue to recover from the pandemic, this will further support housing market activity.

The UK's investment environment has been boosted by the country's orderly withdrawal from the European Union, in addition to the roll out of multiple COVID-19 vaccines. Yet the path to full economic recovery is likely to be characterised by continued uncertainty around the path of the pandemic, both in the UK and globally.

Although we do not expect housing market weakness in the short term, this could result if the economic recovery from the pandemic were derailed; in which event, we would expect residential real estate's defensive characteristics to bolster values relative to other asset classes, as demonstrated in previous downturns.

Furthermore, the pandemic does not change the fundamental fact that demand exceeds the supply of housing the UK. If anything, this imbalance is likely to worsen given the effects of lockdowns on housebuilding. This points to an upward trend in house prices in the long term and underpins the investment case for the sector.

The specific characteristics of Shared Ownership mean that the sector is expected to be a more defensive part of the residential market during the pandemic. From an occupier's perspective, a house is not discretionary spend but a basic need and so, even during a severe recession, we believe owners will still prioritise their mortgage repayments. This was the case during the Global Financial Crisis, when repossession rates on mortgages remained very low (0.43% of outstanding mortgages in 2009)[8].

From an investor's perspective, even if there is some degree of housing market weakness, falls in house prices will, to some extent, be offset by the RPI-linked nature of the rental stream. Rental growth is likely to remain positive for Shared Ownership as a result. While rents are likely to fall elsewhere in the property market, Shared Ownership is expected to perform relatively better than other asset classes during the crisis.

An institutional investment opportunity

Diversification benefits

Property has different market drivers to those of more traditional investments such as equities and bonds, and consequently shows very low correlation with those asset classes. The residential sector is also a suitable portfolio diversifier for commercial property investors, based on its much lower correlations with most traditional property sectors than those sectors show with each other.

Therefore, Shared Ownership investment is complementary to other, more traditional residential sector investments, such as those focused on the PRS, as it is well placed to benefit investors seeking to diversify portfolios towards reversionary investments and long-term income. This is attractive in the late cycle environment, as index-linked rents are defensive in an economic downturn. The income stream is further enhanced by the defensive nature of the Shared Ownership occupier base. As the occupier has a vested interest in their property, delinquency rates are low (similar to first-time buyer delinquency rates).

Secure index-linked income

For investors, the Shared Ownership sector offers an attractive stream of low volatility, secure, index-linked income. The occupier pays a regular, inflation-linked rent to the investor which is delivered over the long term, similar to fixed or inflation-linked bonds, secured on real estate assets.

The investment is secure as rent is set at a sustainable level and is tied to a property with stable occupiers who consider the property their home. Meanwhile, contracted rental uplifts linked to inflation also create growth in the income stream and provide inflation protection for the investor.

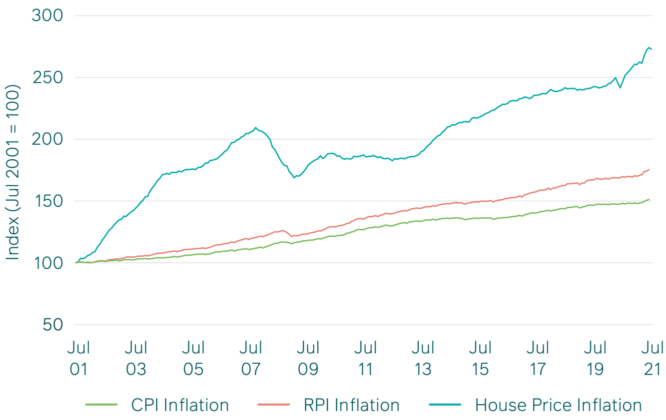
[8]DCLG, August 2014.

Figure 4 Residential property total returns show low correlation with other asset classes

	Residential real estate	Commercial real estate	Equities	Gilts
Residential real estate	1.0	0.6	0.3	-0.1
Commercial real estate	0.6	1.0	0.3	0.0
Equities	0.3	0.3	1.0	0.2
Gilts	-0.1	-0.0	0.2	1.0

Source: MSCI UK Annual Property Digest 2020, MSCI Annual Residential Digest 2020, Bloomberg, M&G Real Estate (inflation-adjusted total returns, 1981-2020).

Figure 5 House price growth versus inflation, % per annum



Source: ONS, Nationwide, August 2021.

Capital appreciation potential from house price growth exposure

Owning a proportion of the underlying real estate provides the potential for long-term capital appreciation. The investor can realise the value of the underlying asset as the occupier staircases and the property receives a mark-to-market valuation over the hold period.

Staircasing receipts can either be distributed or reinvested. Under the right management model, any loss to rental income as a result of staircasing can be overcome through a re-investment strategy, providing an opportunity for investors to maintain or enhance inflation-linked income. This promotes steady rental income streams over the long term.

House price growth forecasts suggest the potential for healthy capital appreciation over the long term. UK house prices have grown at a rate of 5.3% per annum over the last 20 years (2000-2020)[9], significantly faster than RPI inflation. A mismatch between supply and demand, driven by population growth and a reduction in household size, is one of the main factors behind the strong historic growth in house prices. Going forward, demographic pressures are expected to continue to drive demand for housing, particularly around urban areas with strong employment opportunities.

[9]Nationwide, July 2021. ONS, March 2021.

Aligned investors and occupiers

Occupiers are aligned with investors through the joint ownership of the asset. Shared Ownership investments are cost-efficient for investors as occupiers are responsible for all internal repairs and maintenance of the property, including service charges. Landlords are responsible for essential repairs to the external fabric of the building and many of these costs are managed through obtaining warranties.

Government and legislative support

In the UK, Shared Ownership continues to be a political focus and institutional investors have been called upon to help with its delivery. In the 2015 Autumn statement, the government signalled that Shared Ownership should be considered a key means to tackle the challenges of home ownership; £4.1 billion of funding was dedicated towards driving housebuilding in the sector and raising its profile. This was followed by the 2017 Housing White Paper, which outlined the ambition for the number of Shared Ownership properties to grow by 70% over the subsequent five years.

In the 2018 Budget, the government introduced a stamp duty exemption for first-time buyers of Shared Ownership properties of up to £500,000. In certain circumstances stamp duty exemptions are also available to Registered Providers. In addition, the Budget in March 2020 included a further £12 billion of funding for affordable homes, some of which will target the Shared Ownership sector.

Illustrating the government's support of the tenure and desire to see it grow, a number of changes to the Shared Ownership model have been announced. These changes will apply from 2021 until 2026 and are focused on making the tenure more attractive and accessible for occupiers. We expect that the new model will further boost demand for Shared Ownership at a time when the sector is already undersupplied, suggesting significant future growth potential.

Execution

Acute affordability constraints and government support for the sector contributed towards Shared Ownership completions having reached a six-year high in 2019/20[10]. However, achieving the necessary scale to make institutional investment viable is one of the prevailing barriers to entry for Shared Ownership. The ability to forward-fund and forward-purchase, alongside buying individual standing investments, offers an attractive route for large scale investment into the sector.

One route to entry is by acquiring unrestricted open market units and offering them to the market on a Shared Ownership basis. Alternatively, by having Registered Provider status, an investor can also acquire Shared Ownership units directly from developers through their Section 106 obligation. This could create a significantly deeper market for Shared Ownership investments. Portfolios already trade between housing associations and we believe that this will become more commonplace as an increasing number of investors enter the market. We also expect to see increased opportunities for partnership with developers, as a consequence of the current economic crisis.

Strong track record in residential

M&G is well positioned as a Shared Ownership partner

- Experienced investor, managing residential and Shared Ownership assets since 2000, with an extensive network of industry relationships
- Acknowledged leader in social housing finance; over 20 years and over £6 billion[11] of lending
- Well established platform; c.£3 billion international residential portfolio, over 5,000 units across over 150 schemes
- c.£2.5 billion invested in UK residential
- 33 UK PRS schemes and over 3,500 PRS operating units
- Completed £1 billion of forward funded and forward purchased UK Build to Rent developments, comprising 19 schemes
- Innovative manager: launching the UK's first institutional PRS strategy and forward funding the development of one of the UK's first institutionally funded, Build to Rent housing schemes in North Acton, West London
- Strong ESG credentials with in-house team achieving ten GRESB Green Stars in 2020
- Development of an innovative property management platform, operated by Savills

Conclusion

In the UK, there is clear demand for affordable housing to meet an acute need, particularly in areas with higher house prices. The Shared Ownership sector provides an accessible home ownership solution that can be accessed by the average UK household. Alongside such strong long-term prospects, our research supports the investment case for Shared Ownership in the current uncertain environment, given the benefits of secure, long-term, inflation-linked income streams, house price exposure, as well as diversification.

Experience investing in the residential sector will be key to success in a nascent market, alongside a broad network of relationships with housebuilders, developers and housing associations. Professional investors also have the scope to further optimise returns through economies of scale and greater efficiency. Combining such experience with the opportunity, makes a compelling case, in our opinion, for investing in this burgeoning sector.

[10]Ministry of Housing, Communities and Local Government, December 2020.
Note: All data M&G Real Estate as at 31 December 2020, unless otherwise stated.
[11]M&G Investments, as at December 2020.

Contact

Lucy Williams
+44 (0)20 8162 1035
lucy.williams@mandg.com

Mark Smith
+44 (0)20 8162 1096
mark.smith@mandg.com

www.mandg.com/institutional

M&G Investments