2 July 2020

CIVITAS SOCIAL HOUSING

Index-linked, government-derived income

Civitas derives income ultimately from government payments – predominantly housing benefits. Its portfolio accommodates younger adults with multiple health vulnerabilities. The impact of COVID-19 has been nil, to date, as the income underpins the long-lease rental contracts into which the lessees enter. These are all CPI-linked and typically are of 20 years' term or longer. In a third of cases, the care provider also underwrites the rent payments, in addition to the social housing provider lessee. Civitas is not a passive investor, but takes no development or care risk and, once the lease is signed, it takes no occupancy risk.

- **Strategy and dividends:** Civitas's property provides a cost-effective and clinically superior alternative to institutional care, in a model with cross-party political support. It generated EPRA EPS of 96% the level of dividend payout in 1H'20, rising to 97% in 3Q'20. The current run rate now achieves 100% cover.

- **Capital deployment:** Civitas's investment into the long-dated, index-linked assets is moving towards its stated 35% LTV target. Current acquisitions, and the move to 35% LTV, will principally be newly bespoke higher acuity facilities from third-party specialist developers or care providers, we believe.

- **Valuation and business model:** The stable, rising, long-lease income is inflation-linked. The balance sheet is strong, and covenants have strengthened significantly in the past year. This sector is the first to emerge from the COVID-19 blanket "Material Uncertainty Clause", which the RICS, the valuers' body, mandated.

- **Risks:** Demand is uncorrelated to the economy, but, as with all real estate, the counterpart is crucial. In 2019, some assets were novated to new housing association lessees. The Regulator published a report on this new sector. We see the higher-acuity expansion as an important and focused deepening.

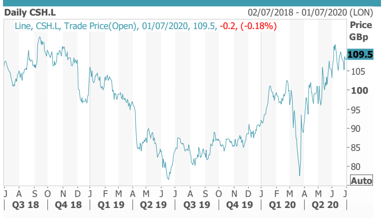
- **Investment summary:** Evolution of the business model is important to note. Assets drive the model – this is a real estate investing company – but Civitas works very closely with the care providers – each house having its own bespoke occupier needs. It is building on this expertise, expanding to higher-acuity assets, with strong partners. A significant positive social impact is generated.

Financial summary and valuation

Year-end Mar (£000)	2018	2019	2020E	2021E	2022E
Revenue	18,606	35,738	46,310	52,180	55,560
EPRA EBIT	9,713	26,096	36,670	42,950	46,140
Revaluation	30,633	3,652	8,360	10,700	17,660
Finance cost	-628	-3,484	-7,480	-8,750	-9,710
C share amortisation*	-2,792	-6,400	0	0	0
Reported profits	36,926	19,864	37,550	44,900	54,090
Statutory EPS (p)	10.6	4.7	6.1	7.3	8.6
EPRA EPS (p)	1.4	3.6	4.7	5.5	5.9
DPS (p)	4.2	5.0	5.3	5.4	5.5
Net (debt)/ cash	150,868	-161,319	-209,040	-310,700	-320,000
EPRA NAV	105.5	107.1	107.8	109.7	112.9
Dividend yield	3.8%	4.6%	4.8%	4.9%	5.0%

**Non-cash accounting of income and assets from follow-on equity; Source: Hardman & Co Research*

Real estate



Source: Refinitiv

Market data

EPIC/TKR	**CSH**
Price (p)	**110**
12m High (p)	111
12m Low (p)	78
Shares (m)	621.6
Mkt Cap (£m)	683
EV (£m)	893
Free Float*	99%
Market	AIM

**As defined by AIM Rule 26*

Description

Civitas is a healthcare residential REIT property, leased to 20-plus years' term, all with CPI-linked rental income. It works closely with care providers, but has no occupancy-related risk. Civitas operates in a growth sector.

Company information

CEO of advisers	Paul Bridge
Manager	Andrew Dawber
Chairman NED	Michael Wrobel

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Key shareholders

Investec Wealth	10.1%
MFS International	6.4%
East Riding Yorks Pension	6.1%
Aberdeen Standard	5.1%
Massachusetts Fin. Serv.	5.0%
FIL Investment	5.0%

Diary

30 Jun	Full-year results
Aug'20	NAV update
Nov'20	NAV update

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Strategy

First UK healthcare-housing REIT

Housing associations and care providers provide covenant support

Civitas Social Housing was created in 2016 as the first dedicated London-listed REIT, to invest in care-based social homes and healthcare facilities. The average occupier age is 32. Income is from long-term leases, not related to occupancy. Demographic-related demand for accommodation is high. Most recently, it has extended its mandate to be able to work directly with leading care-based organisations.

Occupier outcomes, assets, evolution of the model

Sector in significantly rising demographic-led demand

Civitas's housing stock provides a cost-effective alternative to hospitals for young adults with medical needs, including learning difficulties. The assets are leased out to housing associations on long-term CPI-inflating leases. Around 14% of UK social housing is represented by supported housing: a small but fast-growing segment.

Evolution towards higher-acuity accommodation

The housing stock does require specific and relatively extensive re-configuration, which is structural in nature. More explanation of "adaptations" can be found here. Civitas does not develop; it buys from developers and care providers, involving forward purchases. Facilities now extend to high-acuity assets. The largest – in Wales – is set to complete later this calendar year, and is an important evolution. Civitas is still not taking occupancy risk, and it enters into a long-term fixed uplift lease, but the close knowledge of the care providers and the building requirements have enabled this move into a closely allied area, with strong demand-led growth and higher-value properties. There will be further capital allocated to this higher-acuity asset class, where Civitas works closely with its selected care providers, with Civitas finding the buildings, specifying the adaptations required, and bringing in housing associations.

Government funding to lessees

Funding of the lessees – the housing associations – is through housing benefit. There have been specific political policy rulings that this should not be included in changes being made into universal credit regimes.

Execution and dividends

Two large equity raises now fully deployed and investing towards 35% LTV target

Wide range of counterparts

£350m equity capital was raised at an oversubscribed November 2016 IPO, and a subsequent secondary raise of £302m took place a year later. The pre-results update confirmed total invested capital since IPO reaching £789m, made up of 613 properties, fully let to 15 housing associations, supported by 117 care providers in 164 local authorities. There are over 4,200 individual tenants, with a market share of under 1%.

Competitive cost of debt

Average cost of debt stood at 2.46% at the end of fiscal 2020, with a 3.4-year term. This competitive cost of dept indicates covenant strength.

Raised dividend target

With dividends expected to be 100% covered, the target growth for 2021 has been raised, with the dividend expected to reach 5.4p that year.

Social impact

Positive social impact with analysis and quantification of impact

Significant positive social impact is generated. Civitas publishes a social impact report (compiled by a specialist third-party provider) twice yearly, which is worth consulting. There is more information here, with the latest version available.

Civitas's not-for-profit company to benefit society and support covenant strength

The Social Housing Family CIC is a recently formed, not-for-profit community interest company established by Civitas, but operationally independent, whose stated aim is to enable housing associations holding Civitas leases to increase skills and experience, and to provide funding, if required, to promote enhanced performance.

Government regulator's role includes support of corporate governance within housing association sector

The social housing sector is regulated by a government agency, including the specialist supported social housing that Civitas provides. The social housing sector is a stable partner for local authorities, occupiers, investors and other stakeholders. Some individual registered providers may encounter difficulties, but providers have not defaulted. Regulatory interventions assist corporate governance and are materially beneficial, especially to smaller organisations. Supported social housing is fast-growing, and many housing associations participating are specialist and moderately sized. The operational standards of the sector are high.

Valuation

First sector to have COVID-19- related "Material Uncertainty" clause removed

At end-4Q'20 (March 2020), the net initial yield (NIY) of the portfolio stood at 5.26%. There has been an element of yield compression since the time of acquisitions following the IPO, which achieved typically 6%-plus. As we have pointed to as significant, this sector has been the first to emerge from the "Material Uncertainty Clause" that the valuers' body, RICS, mandated, in response to the pausing of real estate markets consequent to COVID-19. This points to the RICS considering there to be a deep and liquid market in this relatively young asset class. Civitas's purchases are prospectively slowing as a result of it moving towards its 35% gearing target. Incremental assets drive much more into the higher-acuity assets.

Peer group: historical valuation ratios and share price performance

REIT	Share price (p)	Price/ EPRA NAV	Dividend yield	Share price change past 12 months
Average secure income REIT Hardman "Basket"*	95	105%	5.0%	-7.0%
Impact Healthcare	95	89%	6.5%	-15%
Target Healthcare	110	102%	6.1%	-5%
Triple Point Social Housing	99	95%	5.1%	+19%
Civitas Social Housing	110	103%	4.6%	+37%

Source: Hardman & Co Research

**Hardman & Co published research in March 2019, "Secure income" REITs – Safe Harbour Available, and May 2020, Safer harbour REITs: an update, including a basket of 16 UK REITs that seek to generate secure income streams as their primary investment mission. A list of these REITs can be found in the May report. Data are historical, and the "Basket" is estimated to see a 10% dividend cut in 2020. Data relate to the weighted average for this basket of 16 REITs, which includes Civitas Social Housing REIT.*

Managers

Civitas Social Housing REIT externally managed by recently renamed Civitas Investment Management Ltd

Civitas Social Housing REIT is externally managed by Civitas Investment Management Ltd. It is of interest that the adviser was, until recently, named Civitas Housing Advisors. Residential remains the core competence, and this has extended to work directly with the NHS and other leading care-based organisations, as well as higher- acuity accommodation and facilities.

Five non-executive independent directors of Civitas Social Housing oversee the management. Chair is Michael Wrobel, former director of the Association of Investment Companies, and a director of several investment trusts, who has 30 years' experience of investment management. The manager's CEO is Paul Bridge, a leading industry director, previously CEO of Homes for Haringey, and non-executive chairman of the Metropolitan Thames Valley Housing Association.

Fees are 1% of net assets to £250m, then tiered to run to 0.7% of net assets over £1bn.

SWOT analysis	
Strengths	100% rent funded from government-underpinned income streams; all leases CPI-linked, long-term; COVID-19 resilience; nil GDP correlation
Weaknesses	Certain lessees are small organisations – but profile has improved
Opportunities	Expanding into higher-acuity assets, which may have more valuation upside
Threats	Regulation changes; interest re-finance 2023

Source: Hardman & Co Research

Investment conclusion

Tested, refined, evolved model

- This model has been refined, through expertise gained in specifying and managing clinical assets, strengthening Civitas's proposition to all stakeholders, including, importantly, Local Authorities' commissioning officers.

Government income, but not government-guaranteed in any way

- It is important to note that income streams are funded by the government, but these pass through local government and the lessees, the housing associations, which are closely government-regulated but not government-guaranteed

2019 strengthening of model

- Civitas has re-assigned some of its leases, strengthening the mix. One small housing association constituted ca.20% of the rent roll in March 2019, and has now reduced to ca.6%. It is noteworthy and should be emphasised that this was all achieved on the same terms – rent and length of lease – as the original lease. Civitas has shown resilience in engaging with stakeholders, including the Regulator, and has "proven the model" in the past year and more.

Income strength translates to good dividend prospects

- Civitas's income profile is particularly attractive, with long leases (well in excess of 20 years), and all income is CPI-linked and ultimately government-backed.
- It is still optimising the rent roll and gearing, but has now reached 100% dividend cover, on growing payouts per share.

Financial summary and valuation

Year-end Mar (£m)	2018	2019	2020E	2021E	2022E
Revenue	18,606	35,738	46,310	52,180	55,560
Expenses	-8,893	-9,642	-9,640	-9,230	-9,420
Underlying EBIT (pre-revaluation)	9,713	26,096	36,670	42,950	46,140
Revaluation	30,633	3,652	8,360	10,700	17,660
Operating profit	40,346	29,748	45,030	53,650	63,800
Finance cost	-628	-3,484	-7,480	-8,750	-9,710
C share amortisation[1]	-2,792	-6,400	0	0	0
Pre-(and post-) tax profits	36,926	19,864	37,550	44,900	54,090
EPRA earnings [2]	9,085	22,612	29,190	34,200	36,430
EPRA EPS (p)	1.44	3.63	4.69	5.50	5.86
Dividend per share (p)	4.25	5.00	5.30	5.40	5.50
Investment properties	516,222	820,094	865,100	979,480	1,009,920
Net cash/(debt)	150,868	-161,319	-209,040	-310,700	-320,000
Other assets[3]	-297,695	7,733	14,690	13,300	12,090
Net assets	369,395	666,508	670,760	682,080	702,010
NAV per share (p)[4]	105.5	107.1	107.8	109.7	112.9
Shares in issue (average)[5]	350.0	425.4	622.1	621.6	621.6
Shares in issue (year-end)[5]	350.0	622.5	621.6	621.6	621.6
P/NAV (x)	104.1	102.7	101.9	100.3	97.4
Dividend yield	3.8%	4.6%	4.8%	4.9%	5.0%

Source: Hardman & Co Research

[1]Non-cash accounting of income and assets from follow-on equity

[2] Equating to profits after interest pre revaluation of assets, excluding C share accounting (non-cash) amortisation and other adjustments

[3]2018 includes £298.7m C shares as balancing accounting debit – ultimately converted to ord. shares

[4]EPRA NAV for Civitas equates to IFRS NAV

[5]Excludes C shares, which were all subsequently converted to ordinary shares

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The full detail is on page 26 of the full directive, which can be accessed here: http://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-regulation-2016-2031.pdf

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