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Mr Michael Wrobel
Chairman
Civitas Social Housing plc
29 Farm Street
London
W1J 5RL

cc:
Alastair Moss
Peter Baxter
Caroline Gulliver
Alison Hadden

22 September 2021

Dear Mr Wrobel,

For disclosure, investment funds managed by ShadowFall Capital & Research LLP hold a short position as of 21 September 2021 equivalent to 0.82% of the shares outstanding in Civitas Social Housing plc (Civitas).

We refer to the announcement made by Civitas on 21 September 2021 where:

> *"The Board notes the recent decline in the Company's share price, which it believes is associated with activity from an activist short seller as well as recent press coverage, the content of which it believes to be baseless, incorrect and/or misleading.*
>
> *The Company has spent the last week engaging with major shareholders to discuss the recent activity and remains available to shareholders that wish to engage further."*

In the light of this announcement, we believe it would be beneficial for shareholders of Civitas to receive clarification regarding what the Board "believes to be baseless, incorrect and/or misleading." With this in mind, we have provided a set of questions, in the enclosure below, which may help to achieve greater clarity.

To provide some context to this, we are sure that Civitas' Board would agree that an essential requirement of any investment is quality and transparent information. That way, investors and relevant parties can properly evaluate disclosure and commentary regarding a company's position and prospects. Our short position derives principally from our doubts regarding the below points:

1. The transparency of several disclosures made by Civitas regarding transactions with entities where the directors of Civitas Investment Management retain an economic interest.
2. The "100% government funded framework" which Civitas espouses.
3. The viability and quality of Civitas' rental income, and the risks resulting thereof to Civitas' NAV.

Some may take the view that Civitas is a force for good within the Supported Housing Sector and carries with it strong ESG credentials. However, we believe that the issues we have identified in this letter and its enclosure below store up significant risk, not only to Civitas' shareholders but also carry systemic risk to other stakeholders within the Sector.

Indeed, as reported by the Sunday Times, a senior executive from the Regulator for Social Housing would appear to support our view (our bold for emphasis):

> *'Jonathan Walters, deputy chief executive of the regulator, said that if there was any change in government policy over housing benefit, or if housing associations were left with empty rooms, they could fail to keep up with payments.* ***"This could lead to cashflow problems, which could cause the companies to fail, and that could lead to vulnerable people being put at risk,"*** *he said.'*

Transparency regarding acquisitions, disposals, and leases

Tom Pridmore and Andrew Dawber, who are directors of Civitas Investment Management (CIM), have been investors in an Isle of Man company, Specialist Healthcare Operations Limited (SHO), which acquired businesses from Civitas. Prior to recent reporting by The Sunday Times newspaper, this investment by Messrs Pridmore and Dawber into SHO does not appear to have been disclosed by either Civitas or CIM. As Mr Dawber volunteered to the Sunday Times in his response regarding the lack of disclosure of the SHO investment, *"We haven't wanted this knowledge to be known particularly widely among competitors"*. A corollary of this is that Civitas' shareholders were also kept in the dark regarding the ownership of SHO when Civitas sold operating companies to SHO on several occasions. For brevity, we refer to these operating companies as the "SHO companies".

We are surprised that CIM's management elected not to disclose the relationships between Civitas, the SHO companies, SHO, and Messrs Pridmore and Dawber to Civitas' shareholders since:

- The values of the transactions
  - Run into the millions of pounds.
  - In FY20, accounted for over half of total capital deployed.
  - We believe demonstrate significantly preferential terms to SHO.

Further, we estimate:

- The annual rent received by Civitas from the SHO companies contributed approximately 2%, 6% and 28% to Civitas' growth in rental income during the years FY19, FY20, and FY21, respectively. We view this contribution as being increasingly material and seek clarity from the board as to the exact materiality.

We also note that under the Investment Restrictions of the REIT:

- Civitas appears to be unable to lease properties to for profit companies such as the SHO companies.

So, it seems to us that Civitas has instead leased the properties to its largest tenant, Auckland Home Solutions, which it appears to have de facto control over. Auckland then seems to lease the properties on to the SHO companies.

Finally, we discover, conflicting lease terms where:

- The filings for the SHO companies suggest lease terms of 10 years.
- The filings at the Land Registry suggest lease terms of 10 years.
- The filings by Civitas suggest lease terms of 20+ years.

Under Civitas' investment property valuation (a discounted cashflow derived model) a lease term which is booked by Civitas that is say, twice as long in duration, would be significantly enhancing to its NAV, and in turn the investment management fees which are payable to CIM. If the properties were valued on a 10-year lease term then the attributable net asset value would be lower.

Transparency regarding the "100% government funded framework"

Aside from what we view as a lack of informative disclosure by either Civitas or CIM regarding the above, we have significant reservations regarding the overall viability of Civitas' business model. Indeed, we believe that:

- At least 23% of Civitas' annual rental income could be at risk.
- 48% of Civitas' dividend could be at risk.
- As Civitas' investment property valuation is determined from its rental income, we believe that its NAV could be at risk

Supporting our view, we find that contrary to the widely perceived "100% government funding framework", instead we see many of Civitas' tenants as financially supported by:

- **Loans from property developers.** For example, Westmoreland (Civitas' 5th largest tenant) paid Civitas c. GBP 6.5 million then GBP 7.0 million in rent in FY18 and FY19 respectively. During the same period, Westmoreland received GBP 8.8 million in loans from property developer Fairhome Group. In FY20, Fairhome wrote these loans off and rent received by Civitas from Westmoreland declined to GBP 3.7 million in FY20 then GBP 3.0 million in FY21.
- **Rent support to some of Civitas' tenants from property developers.** Encircle (Civitas' 6th largest tenant) paid Civitas GBP 2.8 million in rent in FY20 then GBP 2.9 million in FY21. In its latest filing, Fairhome indicates it provided GBP 2.9 million in rent support to Encircle. Indeed, Encircle is now indicating to its stakeholders that its goal is to "***diversify our business model to reduce our reliance on the long lease real estate investment trust (REIT) housing model***."
- **Indications that lease incentives may be used to support what would otherwise be insolvent tenants.** For example, while Triple Point Social Housing REIT (a peer of Civitas) reports de minimis lease incentives, we note that Civitas' lease incentives have continued to rise, equating to 23% of annual rent in FY21. What we find to be odd, is why these significant lease incentives exist in the first place. If the rental income is "100% government funded" and the leases are non-cancellable, then it strikes us as odd that they continue to grow when presumably the lease terms had already been entered into by either the developer/Aggregator or Civitas some years prior.

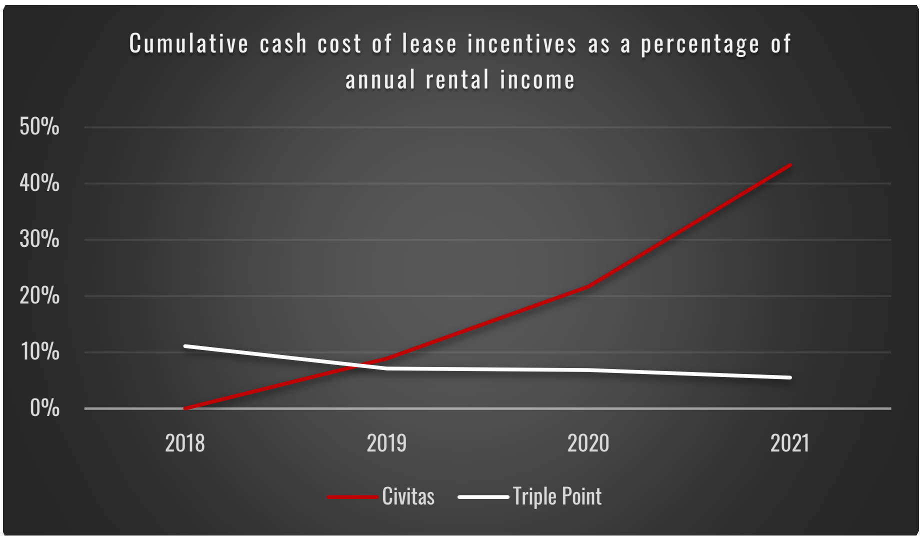

Figure 1 Cumulative cash cost of Civitas and Triple Point's lease incentives as a percentage of respective annual rental income. Source: Company filings, ShadowFall calculations

Given that the significant financing support measures or lease incentives do not originate from the public sector, in our view, it seems a fallacy to refer to Civitas' rent roll as a *"100% government funded framework"*. Yes, in the correctly functioning environment the rent is fully funded by the government, however in Civitas' tenancy base we see the above financial support measures being required. Not only this but if a tenant to Civitas is determined to be non-compliant the Regulator of Social Housing, then the rent is at risk of not being funded by the government. These financial support measures might also explain why:

- Despite Civitas' run rate EPRA earnings cover of the dividend being 100%, historically, we calculate that the real cash coverage of the dividend has only been at 50% - 60%.
- In FY21, disposable cash coverage of the dividend was at its lowest point since listing.

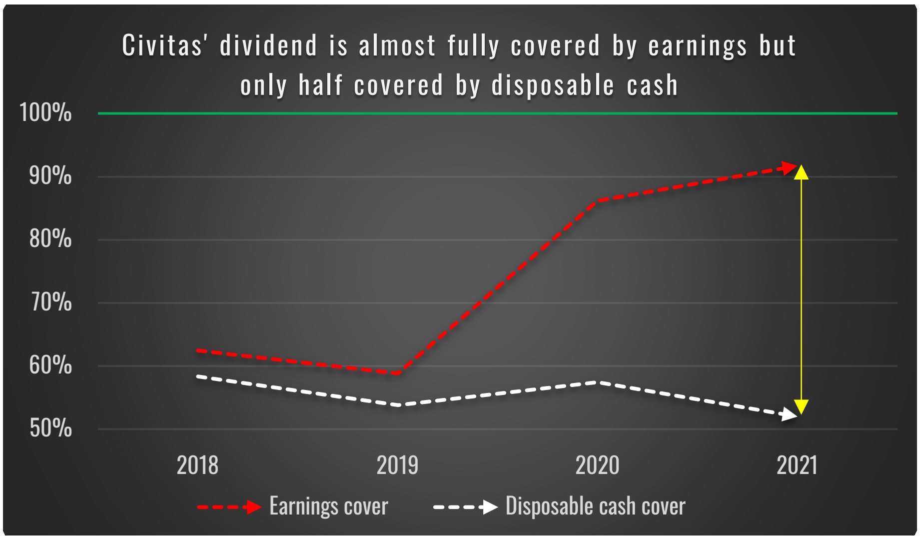

Figure 2 Civitas dividend cover by earnings and disposable cash. Source: Company filings, ShadowFall estimates

Tenant concentration risk

Auckland Home Solutions and Falcon Housing account for a combined 44% of Civitas' rental income in FY21. We believe that this concentration of rental income presents a significant risk when considering that we have found:

- Common director overlap between the two tenants, Auckland and Falcon.
- Indications that the overlapping directors also own a property development company which has sold properties to Civitas.
- Both Auckland and Falcon's accounts to be unaudited (an outlier among other Registered Providers).
- Falcon's accounts to be unreliable since they appear to contain numerous financial entries which have been copied and pasted from prior years.
- Inconsistencies between the annual rental income which Civitas suggests is secured from Falcon, and the annual rental income which Falcon believes it is obligated to pay.

As Chairman to Civitas, you will likely be aware of much of the detail that follows. However, we feel it helpful to provide reasonable context, including diagrams and copies of original corporate filings, so that if anything comes as a surprise, you are able to see the evidence which has informed our view and verify for yourself how this has occurred.

We believe it would be beneficial to stakeholders for Civitas to provide clarification to the questions we have set out in the enclosures below.

Thank you for your consideration on this matter.

Yours sincerely,

Matthew Earl
Managing Partner
ShadowFall Capital & Research LLP

ENCLOSURE.

Civitas Social Housing plc (Civitas)

Civitas Social Housing is a Real Estate Investment Trust (REIT) investing in care-based community housing and healthcare facilities for working-age adults in the UK. Civitas was admitted to the main market for listed securities of the London Stock Exchange in November 2016 and is listed on the premium listing segment of the Official List of the Financial Conduct Authority.

Civitas rents properties to Registered Providers (RPs), providing c. 4,391 tenancies in its 648 properties.

Civitas Investment Management (CIM)

Civitas is advised by Civitas Investment Management Limited (CIM) which is authorised and regulated by the Financial Conduct Authority under the Firms Reference Number 815699.

CIM is managed by:

- Paul Bridge, CEO Social Housing
- Tom Pridmore, Group Director
- Andrew Dawber, Group Director

TLC Care Homes acquired by Civitas and sold to Specialist Healthcare Operations

Between December 2018 and March 2020, Civitas acquired three companies for a combined value of GBP 45.3 million. Civitas held on to the properties within these companies and sold the operating companies for GBP 6.6 million to entities which are ultimately owned by an Isle of Man based company, Specialist Healthcare Operations Limited (SHO).

16. Subsidiary resale

	For the year ended 31 March 2020 £'000	For the year ended 31 March 2019 £'000
Balance at the beginning of the year	–	–
Acquisition	19,829	25,470
Transfer to investment property	(17,608)	(21,134)
Sale proceeds	(2,221)	(4,336)
	–	–

On 11 March 2020, the Group entered into a transaction to acquire the freehold properties operated by New Directions Flexible Social Care Solutions Ltd and Vision MH Ltd. Upon the acquisition of the companies for £19,829,000, investment properties were transferred into other Group companies and the companies, along with their associated operations, were sold to TLC Care Homes Limited for £2,221,000.

On 7 December 2018, the Group acquired a subsidiary, TLC Care Homes Limited, for £25,470,000 consisting of investment property and a care home business with the exclusive intent to sell the subsidiary business. At acquisition, the fair value of the investment property was £21,134,000 and the fair value of the assets and liabilities less selling costs of the care home business was £4,336,000. The care home business was sold immediately following acquisition for £4,336,000.

Figure 3 Disclosure of the acquisition and disposal of TLC Care Homes. Source: Civitas Annual Report

Tom Pridmore and Andrew Dawber, who are directors of Civitas Investment Management (CIM), have been investors in the Isle of Man company, Specialist Healthcare Operations Limited (SHO), which acquired these businesses from Civitas. Prior to recent reporting by The Sunday Times newspaper, this investment by Messrs Pridmore and Dawber into SHO does not appear to have been disclosed by either Civitas or CIM. As Mr Dawber volunteered to the Sunday Times in his response regarding the lack of disclosure of the SHO investment, *"We haven't wanted this knowledge to be known particularly widely among competitors"*. A corollary of this is that Civitas' shareholders were also kept in the dark regarding the ownership of SHO when Civitas sold operating companies to SHO on several occasions.

We estimate that these three businesses achieved a combined trailing EBIT of GBP 5.0 million in 2018. We appreciate that these days, valuations are even more of an art-form than ever before. Nonetheless, we believe this represents significantly preferential terms for SHO as the valuation paid does not appear to us to be particularly onerous. Even if rather than paying c. 1.3x FY18 EBIT, SHO had instead paid 3x EBIT, it would still strike us as a good deal for SHO. We exclude fees paid by SHO in this transaction as presumably Civitas shareholders will never receive this cash. Further, we believe that this is a material transaction since it not only incorporated the sale of the operating companies to SHO, but as we go on to detail below, also the leaseback of the properties by Civitas to the SHO owned operating companies.

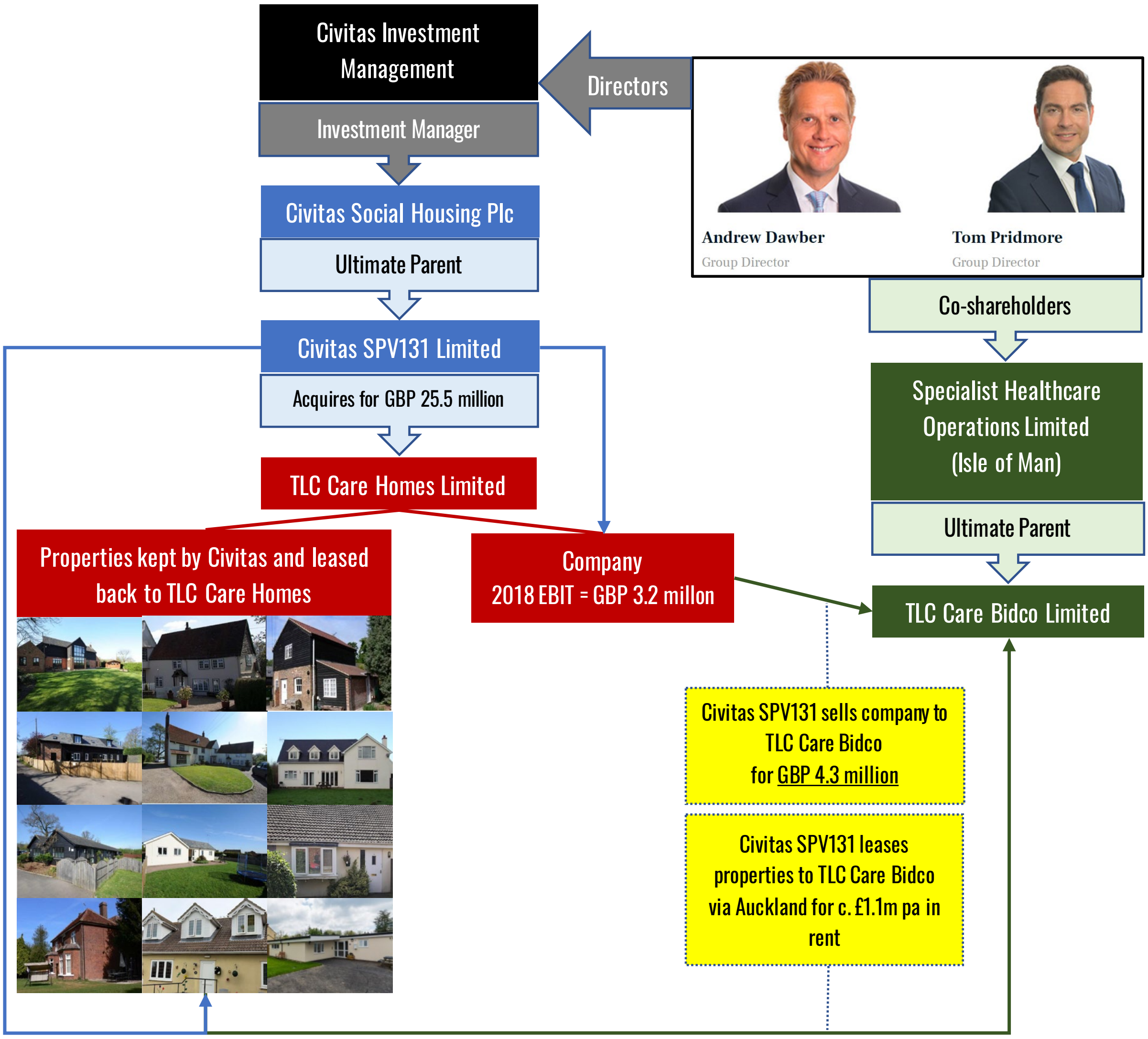

Figure 4 Acquisition and disposal of TLC Care Homes. Source: Company filings, ShadowFall

Civitas leases the properties back to Specialist Healthcare Operations

Having sold the three operating companies to SHO, matters become further muddied when we discover that Civitas appears to then lease the properties associated with these acquisitions indirectly back to these three companies. Filings for the three operating companies which were sold to SHO (we refer to these as **the SHO companies**) suggest since entering these leases they now pay a combined c. GBP 1.9 million in annual property lease expense. If correct then Civitas has paid gross GBP 45.3 million for these businesses, the opcos were sold for GBP 6.6 million, for a net GBP 38.7

million. **Rent of GBP 1.9 million would correspond to a 4.9% gross rental yield, compared to an average purchase yield of 5.84% reported in Civitas' 2021 Annual Report**. Further, based on the timing of these acquisitions, we calculate that the annual rent received by Civitas from the three SHO companies contributed approximately 2%, 6% and 28% to Civitas' growth in rental income during the years FY19, FY20, and FY21, respectively. We would also note that in FY20, the capital which was allocated to the SHO companies equated to over half of total capital which was deployed in that year.

Or does Civitas lease properties back to Specialist Healthcare Operations? The Investment Restrictions of the REIT

One of the Investment Restrictions of Civitas' REIT stipulates that:

"The Company only invests in Social Homes where the counterparty to the lease or occupancy agreement is an Approved Provider".

Presumably, under these restrictions, Civitas could not lease properties to for-profit companies. The SHO companies are for-profit companies and are not Approved Providers. However, Auckland Home Solutions (Auckland) is an Approved Provider. Fortunately for Civitas, in addition to Auckland being its largest tenant by rent (24% as of FY21), we find that Civitas appears to also have de facto control over Auckland. Civitas formed The Social Housing Family CIC (TSHF) in November 2018. According to filings with UK Companies House, TSHF has significant control over Auckland.

In August 2021, the Regulator of Social Housing (RSH) deemed Auckland as non-compliant regarding Governance and Financial Viability. Further, that Auckland had entered lease transactions with related parties that were material and increasing long-term viability risks to Auckland. We will come on to this later. For now, we find that Auckland – which is an Approved Provider and effectively controlled by Civitas – appears between Civitas as landlord and the SHO companies as the ultimate tenants. By slotting Auckland in as a "middleman", we believe it helps Civitas to be compliant with the Investment Restrictions of the REIT, which otherwise may not be the case.

Conflicting terms

Then we find conflicting versions of events regarding the lease terms between Civitas, Auckland and the SHO companies. For example, the filings for SHO companies suggest lease terms of 10 years. The term of 10 years is also echoed by Land Registry filings. By contrast, Civitas' filings seem to suggest that the lease terms are twice as long.

For example, in the case of one of the SHO Companies, TLC Care Homes Limited (TLC CH), Civitas SPV131 appears to us to be the SPV which is used by Civitas to hold the properties which are indirectly leased to TLC CH. These properties are detailed on TLC CH's website and some are shown in figure 6 below.

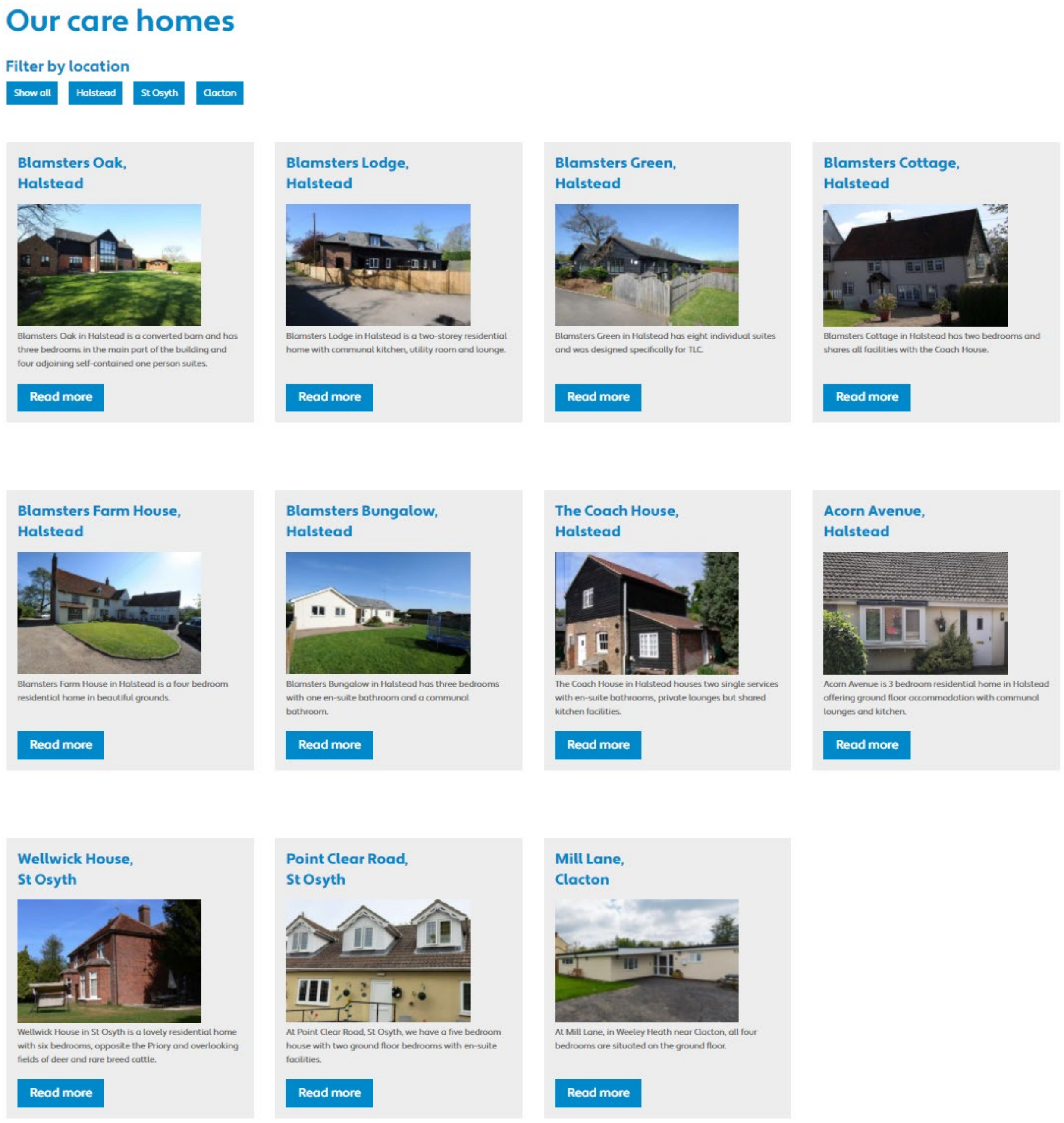

Figure 5 TLC Care Homes properties. Source: TLC Care Homes website, ShadowFall

Filings at UK Companies House and the Land Registry details show the TLC CH properties with registered owner and leaseholder as listed below:

Civitas SPV131 Limited Properties

Address	Lender	Registered owner	Leaseholder	Land registry price stated, £	Lease term
18 Acorn Avenue, Halstead, CO9 1LQ	None	Civitas SPV131	Auckland Home Solutions CIC	874,987	10 years to Dec 2028
Land adjoining Blamsters Farm, Mount Hill, Halstead, CO9 1LR	Natwest	Civitas SPV131	Auckland Home Solutions CIC	416,000	10 years to Dec 2028
Blamsters Farm, Mount Hill, Halstead, CO9 1LR	Natwest	Civitas SPV131	Auckland Home Solutions CIC	11,219,895	10 years to Dec 2028
Blamsters Link, Howe Chase, Halstead, CO9 2QJ	Natwest	Civitas SPV131	Auckland Home Solutions CIC	1,240,784	10 years to Dec 2028
25 Primley Lane, Sheering, Bishop's Storford, CM22 7NH	None	Civitas SPV131	Auckland Home Solutions CIC	550,000	10 years to Dec 2028
Donyland Lodge, Fingringhoe Road, Colchester, CO5 7JL	Natwest	Civitas SPV131	Auckland Home Solutions CIC	1,558,694	10 years to Dec 2028
21 Mill Lane, Weeley Heath, Clacton-On-Sea, CO16 9BB	Natwest	Civitas SPV131	Auckland Home Solutions CIC	1,372,956	10 years to Dec 2028
165 Point Clear Road, St Osyth, Clacton-On-Sea, CO16 8JB	Natwest	Civitas SPV131	Auckland Home Solutions CIC	1,048,673	10 years to Dec 2028
Wellwick House, 100 Colchester Road, St Osyth, Clacton-On-Se:	Natwest	Civitas SPV131	Auckland Home Solutions CIC	1,881,655	10 years to Dec 2028
				20,163,644	

Figure 6 Lease details for the TLC CH properties. Source: Land Registry filings, ShadowFall

Aside from the leaseholder being Auckland and not one of the SHO companies, TLC CH, what we find surprising is that Civitas SPV131 indicates in its annual filing that the leases for its properties are to a single Registered Provider (presumably Auckland as per figure 6 above) and are for a duration to 2040 (see figure 7). Further, that the total future minimum lease receivables under non-cancellable operating leases total GBP 23.3 million as of 31 March 2020.

Civitas SPV131 Limited
Notes to the Financial Statements
for the period from incorporation on 13 November 2018 to 31 March 2020

13 Operating leases

The Company's investment properties are leased to a single Registered Provider under the terms of a commercial property lease due to expire on 6 December 2040 and with index linked annual rent reviews. The Company's current leases are Full Repairing and Insuring ('FRI') leases, the tenants are therefore obliged to repair, maintain and renew the properties back to the original conditions.

Total future minimum lease receivables under non-cancellable operating leases fall due as follows:

	Investment Property 31 March 2020 £
Falling due:	
within one year	1,125,748
within two to five years	4,502,991
in over five years	17,654,874
	23,283,613

Figure 7 Civitas SPV131 version of events regarding lease values and terms. Source: Company filings, ShadowFall

However, TLC CH's annual report shows a lease term, which implies less than 10 years, and a future minimum lease payment of GBP 8.4 million, not the GBP 23.3 million as Civitas SPV131 seems to report.

TLC CARE HOMES LIMITED

Notes to the Financial Statements for the Period from 31 March 2019 to 31 March 2020

19 Obligations under leases and hire purchase contracts

Operating leases

The total of future minimum lease payments is as follows:

	2020 £ 000	2019 £ 000
Not later than one year	979	1,279
Later than one year and not later than five years	3,887	3,964
Later than five years	3,561	4,533
	8,427	9,776

Figure 8 TLC CH version of events regarding lease values and terms. Source: Company filings, ShadowFall

Further, the Land Registry details for these leaseholds almost always show lease terms of c. 10 years (see figures 9 and 10) with an option to renew upon the terms of the lease.

REGISTER EXTRACT

Title Number	: EX982932
Address of Property	: Blamsters Farm, Mount Hill, Halstead (CO9 1LR)
Price Stated	: Not Available
Registered Owner(s)	: AUCKLAND HOME SOLUTIONS CIC (Co. Regn. No. 07345564) of Glendale House, Rose Avenue, Blackhall Colliery, County Durham TS27 4JQ.
Lender(s)	: None

Figure 9 Land registry lease details for Blamsters Farm. Source: Land Registry, ShadowFall

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7      (08.01.2019) Short particulars of the lease(s) (or under-lease(s))
       under which the land is held:
       Date         : 21 December 2018
       Term         : 10 years commencing on 21 December 2018 and ending on 20
                      December 2028
       Parties      : (1) Civitas SPV131 Limited
                      (2) Auckland Home Solutions CIC
       NOTE 1: The lease contains an option to renew upon the terms therein
       mentioned
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Figure 10 Land registry lease details for Blamsters Farm. Source: Land Registry, ShadowFall

So, which is right and why is it important?

Lease values contribute to Civitas' book value for investment property. All else equal, the longer the lease term, the higher the value of the corresponding investment property, the higher the value of Civitas' Net Asset Value (NAV) and the higher the management fees that are accrued by CIM for managing the REIT. Presumably a lease term which is booked by Civitas that is say, 20 years, is significantly more accretive to the NAV and thus higher investment management fees are payable to CIM. To put this into context, given these SHO companies indicate that they pay annual rent of c. GBP 1.9 million to Civitas, on a 20-year lease term, growing at 2% annually and discounted at the average discount rate used by the valuer in 2021, 6.0% we calculate that this equates to an investment property value of c. GBP 25.5 million. If CIM earns a 1% pa management fee on this, then this is GBP 255,000 pa. By contrast, a 10-year lease would be only 60% of this Investment Property valuation. Further, the higher the book value of the investment property, the lower the Loan to Value (LTV) ratio; no doubt benefiting Civitas by providing comfort to its debt providers.

In the light of the above, we have several questions which we believe your investors may find helpful to have answered:

1. When was the board made aware that Mr Pridmore and Mr Dawber were investors in Specialist Healthcare Operations (SHO)?
2. How did the board arrive at the valuations for the operating companies which were sold to entities which are ultimately owned by SHO?
   We note commentary by Civitas in the press which suggests in the case of TLC Care Homes, that SHO incurred costs of c. GBP 1 million relating to this acquisition. Given the GBP 4.3 million acquisition cost, this seems a high-cost burden. Irrespective of costs incurred by SHO, the value received by Civitas's shareholders is GBP 4.3 million which is what matters.
3. What EBIT did New Directions and VMH achieve in the year prior to the purchase by Civitas and disposal to entities ultimately owned by SHO?
4. At the time of these disposals, what were the equity interests in SHO either through personal shareholdings or holdings through other vehicles?
5. Why was the decision made to not disclose these transactions to Civitas' investors as related party in nature?
6. Are these the only transactions involving Civitas and SHO or other entities in which Messrs Dawber and Pridmore retain an economic interest? If not, what other transactions are there?

We note in the responses provided to the Sunday Times, that Mr Dawber claims that he and Mr Pridmore were "*asked to take small stakes [in the companies acquired by Specialist Healthcare Operations] by the care provider, ...*".

7. Could you provide greater disclosure around the rationale as this is unclear. Which care provider, is the care provider independent?

Further, again in response to the Sunday Times, regarding why the investment in SHO was not made public, Mr Dawber also states: *"We haven't wanted this knowledge to be known particularly widely among competitors."*

8. Could you elaborate why this might be? As this transaction appears to be poor for shareholders at a 4.9% purchase yield compared to the group average purchase yield of 5.84%.
9. Why was it decided that Auckland Home Solutions (which in FY21 was Civitas' largest tenant, and for which it appears Civitas has de facto control over) should be the tenant to Civitas for the TLC CH, New Directions and VMH properties?
10. Why do the three SHO companies not lease the properties from Civitas directly?
11. Since the SHO companies are ultimately co-owned by Messrs Pridmore and Dawber, and are also indirect tenants to Civitas, how was the rent level determined? Can you reconcile the lease term disclosure contradictions?
12. Why does Civitas SPV131 future minimum lease receivable under non-cancellable operating leases of GBP 23.3 million, which are GBP 14.9 million greater than the future minimum lease payments of GBP 8.4 million, which TLC CH represents in its annual filing? Are there other leases aside from those relating to TLC CH within the Civitas SPV131 figure which make up the difference?

The reason we ask is that GBP 14.9 million is a sizeable difference and if this is embedded into the Net Asset Value of Civitas, then investors need to have surety over these lease terms.

The Rent Roll

Contrary to Civitas describing its funding cycle as a "100% government funded framework" our view is that Civitas' rent roll is not 100% government sourced.

We believe that:

- At least 23% of Civitas' annual rental income is at risk.
- 48% of Civitas' dividend could be at risk.
- As Civitas' investment property valuation is determined from its rental income, we believe that its NAV could be at risk.

Supporting our view, we find that contrary to the widely perceived "100% government funding framework", instead we see many of Civitas' tenants as financially supported by:

- Loans to some of your tenants from property developers.
- Rent support to some of your tenants from property developers.
- Indications that lease incentives may be used to support what would otherwise be insolvent tenants.

Given that these financing support measures do not originate from the public sector, in our view, this does not strike us as a "*100% government funded framework*".

It might also explain why:

- Despite Civitas' run rate EPRA earnings cover of the dividend being 100%, historically, we calculate that the real cash coverage of the dividend has only been at 50% - 60% (figure 11).
- In FY21, disposable cash coverage of the dividend was at its lowest point since listing.

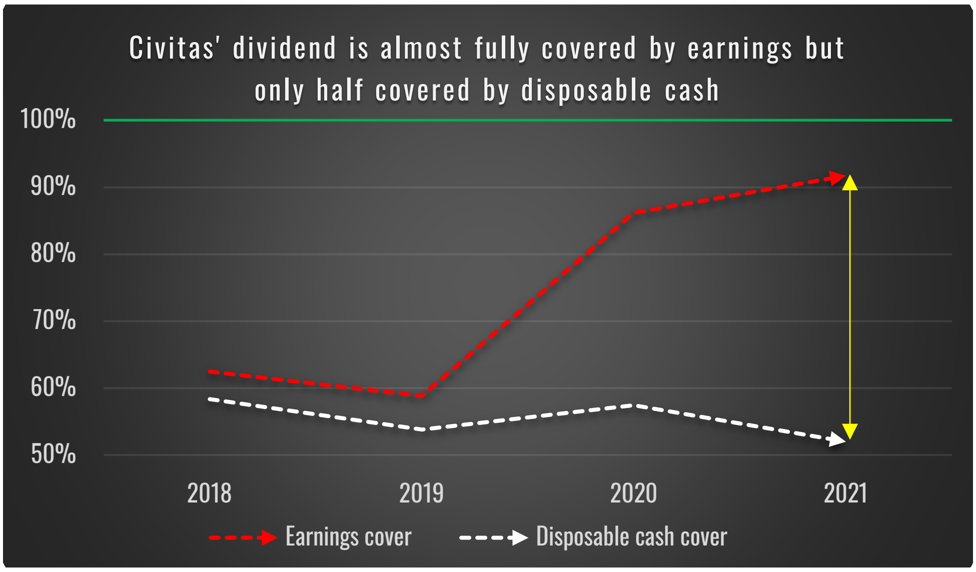

Figure 11 Civitas dividend cover by earnings and disposable cash. Source: Company filings, ShadowFall estimates

Civitas' shareholders might believe that the dividend is paid out of earnings, and that its NAV is supported by long dated government backed leases. We see a different picture where the dividend is largely covered by either debt financing or previous capital injections from shareholders, and some of its tenants have only remained solvent due to private sector loans, rent support and/or lease incentives. Irrespective of this apparent merry go round of capital to date, it does not strike us as sustainable.

Civitas' model appears to be relatively straightforward, and we have detailed in the boxed section below how we see it:

The model

In society there are vulnerable persons who require a combination of independent living accommodation but with specialist care provision. When this housing requirement is identified, a property developer (Aggregator) will source, purchase, and adapt a property for such a vulnerable person to be accommodated under Specialist Supported Housing (SSH).

The Aggregator will liaise with a Registered Provider (RP) or Housing Association and strike a lease deal with the RP, where the RP becomes obliged to make monthly rental payments, linked to inflation, typically lasting for 25 to 30 years. A Care Provider will be arranged to provide ongoing care to the tenant. The Aggregator will then sell the home on – including the lease – to an investor for a profit. The RP, which is invariably small, gets to grow and the investor gets a steady rate of income in theory funded by the government via housing benefit. *The Aggregator walks away with a tidy profit.*

Civitas' business model begins with the purchase of properties from Aggregators, such as Fairhome Group plc and Global Capital Holdings. When an Aggregator sells the investment opportunity to Civitas, this is typically inclusive of a fee.

Since its November 2016 IPO, Civitas has acquired a portfolio of built Social Homes (valued in FY21 at GBP 915.6m) which it then leases to Registered Providers (RPs) on a long-term basis. An RP's ability to pay the contracted lease income to Civitas depends on the RP's ability to also collect rental income and service fees, which is generally paid for by the Local Authorities (LAs) on behalf of the tenants under the Local Government Finance Settlement. Additionally, LAs will also fully fund the fees for Care Providers, which provide care services alongside the tenancies.

In FY21, Civitas had 16 tenants or Registered Providers (RPs). The view that Civitas' investors appear to take is that the rental income from these tenants is almost guaranteed. This view is presumably driven by Civitas describing its funding cycle as a "100% government funded framework". This is true, provided that the lease arrangements are compliant with rental standards. Let's hope that Civitas' rent roll is compliant then, since it appears to us that many of Civitas' tenants are in significant financial difficulty. Why do we think this? Because either they or the Regulator of Social Housing (RSH) are telling us so.

By way of a few examples:

We note that 9 out of Civitas' 16 tenants have been deemed non-compliant for either governance or financial viability standards or both, by the Regulator of Social Housing.

Civitas' 6th largest tenant by FY21 rent (6%), Encircle Housing, has stated in its latest filing (our bold for emphasis):

> *"**Encircle has sought support from head landlords with rent holidays until Encircle is in receipt of payment on properties**. Post year-end a number of larger debtors' balances have been received and the subsequent clearing of the associated creditor balances has also taken place. **The loan facility will be utilised as a source of funding for working capital to service creditors if required.**"*

More alarmingly, it seems that Encircle is attempting to branch away from the Civitas model (our bold for emphasis):

> *"Our longer-term goal following a period of consolidation in 2020/21 **will be to diversify our business model to reduce our reliance on the long lease real estate investment trust (REIT) housing model**."*

Having a major tenant suggest that it needs to reduce its reliance on your business model does not strike us as a particularly favourable prognosis.

Another example is Civitas' 7th largest tenant by FY21 rent (5.3%), Trinity Housing Association. At the time of writing, Trinity is overdue in filing its FY20 accounts. However, we note that in its FY19 filing, Trinity highlighted (our bold for emphasis):

> *"**The Board accept that Trinity is only able to continue trading with the support of its partners** and that the nature of that support is not formally or legally documented and **should that support be withdrawn, Trinity would not be a going concern.**"*

Or Civitas' 5th largest tenant by FY21 rent (6.1%), Westmoreland Supported Housing Limited. In its FY19 filing, Westmoreland indicated (our bold for emphasis):

> *"Whilst the Board members believe the adoption of the going concern basis is appropriate in these circumstances, they also note the existence of significant uncertainty related to the future viability of Westmoreland, in that **long-term viability is dependent upon successfully restructuring several long-term leases held by Westmoreland** to apportion risk on a more equitable basis.*
>
> *Negotiations between all parties are in progress. **Failure to deliver against these items would create a high risk of insolvency for Westmoreland.**"*

We note that in the case of both Encircle and Westmoreland, these tenants have also been supported by one of the Aggregators (developers), Fairhome Group plc. In its FY20 filing, Fairhome highlights (our bold for emphasis):

> *"**£8.8m was provided to Westmoreland Supported Housing Association** in 2018 and 2019. Since the year end **Fairhome has written off these amounts un-conditionally** which has assisted Westmoreland in its recovery.*
>
> ***Fairhome has supported Encircle Housing with £2.9m in rent support over the year** further to challenges with a care counterparty."*

FAIRHOME GROUP PLC

NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 JULY 2020

14. Exceptional items

	2020 £000	*2019 £000*
Provision for non recovery of funds advanced to related care businesses	**1,803**	*10,446*
Rent support to Encircle Housing	**2,889**	-
Cost of re-structuring shareholdings	**1,240**	-
Payments made on behalf of Change Housing	**510**	*1,500*
Losses incurred during the year in a subsidiary to closure	**557**	-
Provision for non recovery of loans to Westmoreland Supported Housing Association Limited	**-**	*5,029*
Provision for doubtful debts	**427**	-
	7,426	*16,975*

Figure 12 Fairhome Group (a developer) extending loans & rent support to Civitas' 5th & 6th largest tenants by rent. Source: Company filings, ShadowFall

In the light of the above, we have several questions which we believe your investors may find helpful to have answered:

13. If Civitas' funding cycle is indeed a "100% government funded framework" then why are so many of Civitas' tenants borderline going concerns?
14. If Civitas' funding cycle is indeed a "100% government funded framework" then why did Encircle and Westmoreland require GBP 2.9 million in rent support and GBP 8.8 million in loans (which were written off) respectively over recent years from the Aggregator, Fairhome Group?
15. If Encircle and Westmoreland had not received GBP 2.9 million in rent support and GBP 8.8 million in loans respectively from Fairhome Group, would Civitas have collected the full rent which was due from these two tenants? We note that these two tenants alone account for a combined 12.0% of Civitas' FY21 rent.
16. What percentage of Civitas' FY21 rental income was covered by void cover payments?
17. What percentage of Civitas' FY22 rental income is expected to be covered by void cover payments and when does this expire?

Ever rising lease incentives, but for how long?

Lease incentives are common within the Real Estate sector. They are provided to tenants to aid the value case for taking on leases and ultimately support new business wins. Typically, they comprise a rent reduction for an initial period of the lease or some funding support for development of the property. E.g. 50% rent for the first 6 months of the lease or a contribution toward development/fit-out expenses of the tenant.

Logically, therefore, lease incentives should occur naturally upon the below 3 situations:

1) upon winning a new tenant for a new property entering the portfolio;
2) upon the switching from one tenant to a new tenant, churn; or
3) potentially upon renewals.

But what if a tenant (as many of Civitas' tenants appear to have experienced) encounters financial difficulty? Under this scenario, there would obviously be a significant risk to the collectability of the rent, which would prove problematic for the landlord's NAV and its ability to obtain credit. To mitigate against this, we believe that instead of reflecting rent reductions, a lease incentive could be offered to effectively lower the rent. The value of the lease incentive would be capitalised on to the landlord's balance sheet and then amortised over the long life of the lease. Put more simply by way of example, what if a landlord is owed say, GBP 8 million in rent, but its tenant can only cover 75% of this or GBP 6 million. Instead of reflecting a rent write-down of GBP 2 million – which might prompt an NAV impairment and spook the landlord's creditors – the landlord passes an ad-hoc lease incentive of GBP 2 million to the tenant. This can then be used by the tenant to contribute towards the full GBP 8 million in rent which it owes. The landlord then amortises the GBP 2 million over say, the 25 years of the lease.

We note that Civitas has added rising levels of lease incentives onto its balance sheet over recent years.

Unfortunately for Civitas, while these lease incentives have been capitalised to its balance sheet, they have also had a cash outflow cost as follows:

- FY19: c. GBP 3.2 million.
- FY20: c. GBP 6.8 million.
- FY21: c. GBP 11.2 million.

Further, as a percentage of annual rental income, the cash cost has also risen sharply (figure 14).

What we find to be odd, is why these significant lease incentives exist in the first place. For example, as we go on to detail below, Triple Point Social Housing REIT, a peer of Civitas, has de minimis lease incentives. Further, if the rental income is "100% government funded" and the leases are non-cancellable, then it also strikes us as odd that they continue to grow in size when presumably the lease terms had already been entered into by either the developer/Aggregator or Civitas some years prior.

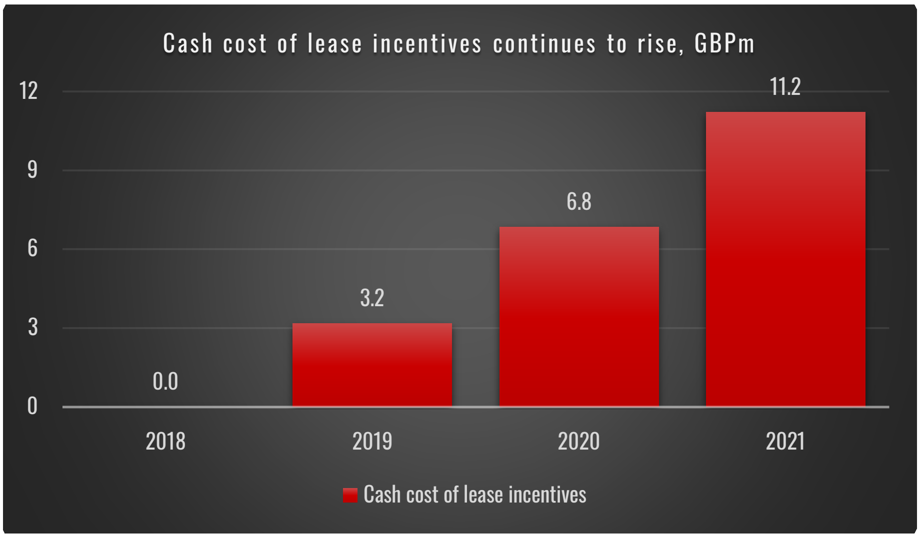

Figure 13 Civitas cash outflows relating to lease incentives. Source: Company filings, ShadowFall

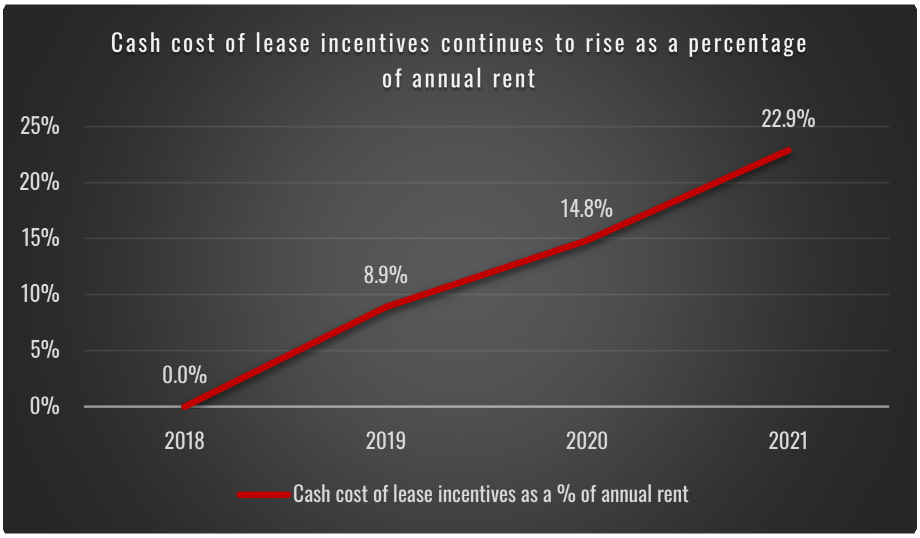

Figure 14 Civitas cash outflows relating to lease incentives as a percentage of annal rental income. Source: Company filings, ShadowFall

To Civitas' credit, regarding this significant rise in lease incentives, the management of CIM have provided an explanation. For example, on the FY21 Earnings Call in June 2021, Andrew Dawber, Group Director for CIM responded to the following question (our bold for emphasis):

Q - James Carswell [Peel Hunt Analyst]

Good morning. And apologies if I'm getting on [ph] old ground. I think Andrew your line broke up slightly when you were explaining the GBP10 million payment, and I'm just circling [ph] back to the August, I think the GBP10 million was mentioned then. I'm just going to work out what changed between then and now. Now [ph] you're a bigger property than you expected or an adjacent property would have some CapEx. ***And who was that payment made to?*** *Assume that is probably a developer. And also, I think last year, there was GBP6.8 million of lease incentives paid which I appreciate is a different line of the accounts. I'm just wondering what that difference is and what that relates to as well, please.*

A - Andrew Dawber [Civitas Investment Management Group Director]

> *Yes, sure. Morning. So the announcement that was made in August last year, I think was just over GBP12 million and within that was the GBP10 million that we're referring to. It's actually a straightforward transaction, it was a property that we acquired effectively in two phases and we agreed to make a further payment as that brand new property came on stream and filled up. So from our perspective, it's a normal transaction but technically we're advised from our auditors that it actually is a lease incentive because it is nothing unusual beyond that. It just so happens that it was a current lease because we made a planned second payment for it and we received commensurate rent at the same yield. So, it just allowed us to take a little bit of time in seeing that property fill up rather than pay for it at a higher level in advance. So hopefully that (multiple speakers).*

Q - James Carswell [Peel Hunt Analyst]

> *I guess -- you said the payment wasn't -- because normally a lease [ph] the payment would be to the tenants.* ***It sounds like in this case it wasn't to the tenant, is that right?***

A - Andrew Dawber [Civitas Investment Management Group Director]

> ***Correct. Yeah. It went through to developer who brought the property through.***

In the light of the above, we have several questions which your investors may find helpful to have answered:

18. Which developer was this lease incentive paid to?

The reason we ask is that as we identified higher above in this letter, Fairhome Group is a developer which has lent GBP 8.8 million to Westmoreland (Civitas' 5th largest tenant by FY21 rent), and provided GBP 2.9 million in rent support to Encircle (Civitas' 6th largest tenant by FY21 rent). In our view, it all seems somewhat circular that developers package properties with tenants and sell these packages to Civitas. Then when some of these tenants encounter difficulty, the developers lend money to the tenants and Civitas provides cash to the developers in the form of lease incentives.

19. Was Fairhome Group the developer that Civitas provided this lease incentive to?
    a. If not, which developer received the lease incentive?
20. Why do Civitas' peers not seem to experience the same cash cost of lease incentives within their accounts?

For example, we note that another listed REIT investor in UK social housing assets, Triple Point Social Housing REIT plc, has de minimis lease incentive costs each year. In fact, since 2018, we calculate that Civitas has incurred c. GBP 21.2 million in lease incentives, as compared to GBP 2.4 million which have been incurred by Triple Point. Why?

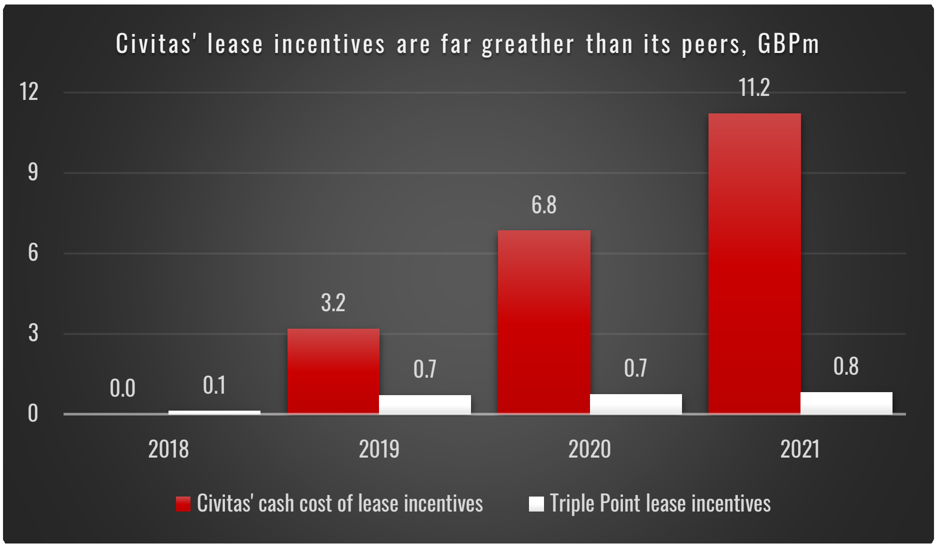

Figure 15 Civitas lease incentives compared to Triple Point. Source: Company filings, ShadowFall

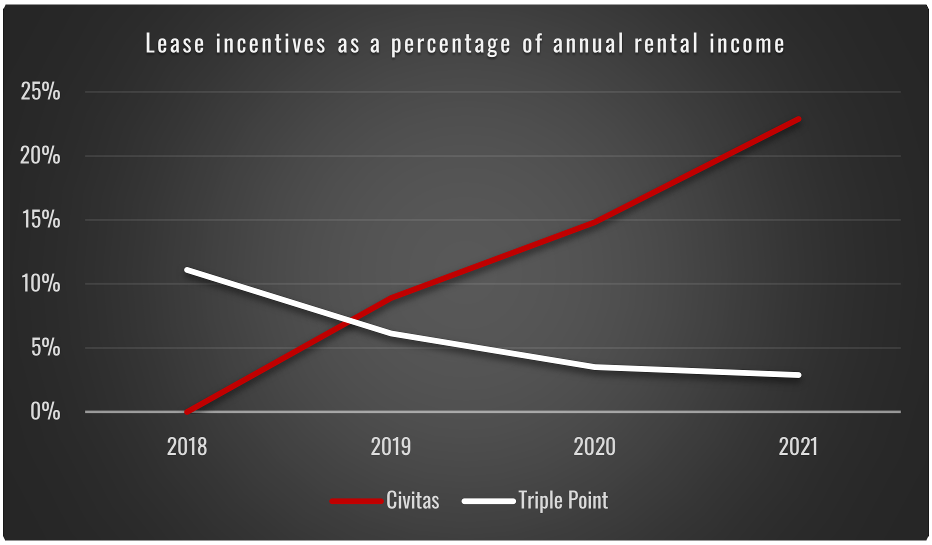

Figure 16 Civitas lease incentives compared to Triple Point as a percentage of annual rental income. Source: Company filings, ShadowFall

Civitas' two largest tenants by rental income

As of FY21, Civitas' two largest tenants by rent were Auckland Home Solutions (Auckland) – accounting for 24% of rent, and Falcon Housing Association (Falcon) – accounting for 20% of rent.

Between Auckland and Falcon, they accounted for 44% of Civitas' rental income in FY21.

According to UK Companies House, Auckland has seven serving Directors. Amongst these are Faisal Lalani and Jamil Mawji.

According to UK Companies House, Falcon has six serving Directors. Amongst these are Faisal Lalani and Jamil Mawji.

Mr Lalani and Mr Mawji are Directors to each of Civitas' largest two tenants by rent.

Mr Lalani and Mr Mawji also own a property development company, Global Capital Holdings Ltd.

As we have detailed above, The Social Housing Family CIC (TSHF) is the Registered Legal Entity (RLE) for Auckland. TSHF was formed by Civitas in November 2018. Effectively we believe this means that Civitas has control over its largest tenant. TSHF's CIC Statement, declares (our bold for emphasis):

> *"The [Social Housing Family] CIC will act as a member of registered providers of social housing, **making decisions as to who should sit on their boards** and ensure that the principles set out in their governing documents are upheld."*

We note that on 13 August 2021, the Regulator of Social Housing (RSH) found that Auckland is non-compliant with Governance and Financial Viability Standards. Further, the RSH stated (our bold for emphasis):

> *"Auckland has been unable to demonstrate that it complies with the Rent Standard."*

And

> *"Our investigations also identified that some of the lease transaction arrangements Auckland has entered into have **involved companies linked to directors of Auckland, and its shareholder** [The Social Housing Family]. For these transactions, on more than one occasion, Auckland sought and received shareholder approval to authorise the reported conflict of interests and disapply the provisions in its articles relating to them. **The transactions were material and on-going and in doing so, Auckland has layered long-term risks onto the business, for which we lack assurance that they can be adequately managed under the current terms.**"*

In figure 17 below, we outline our understanding of the relationships between Civitas and its two largest tenants by FY21 rental income.

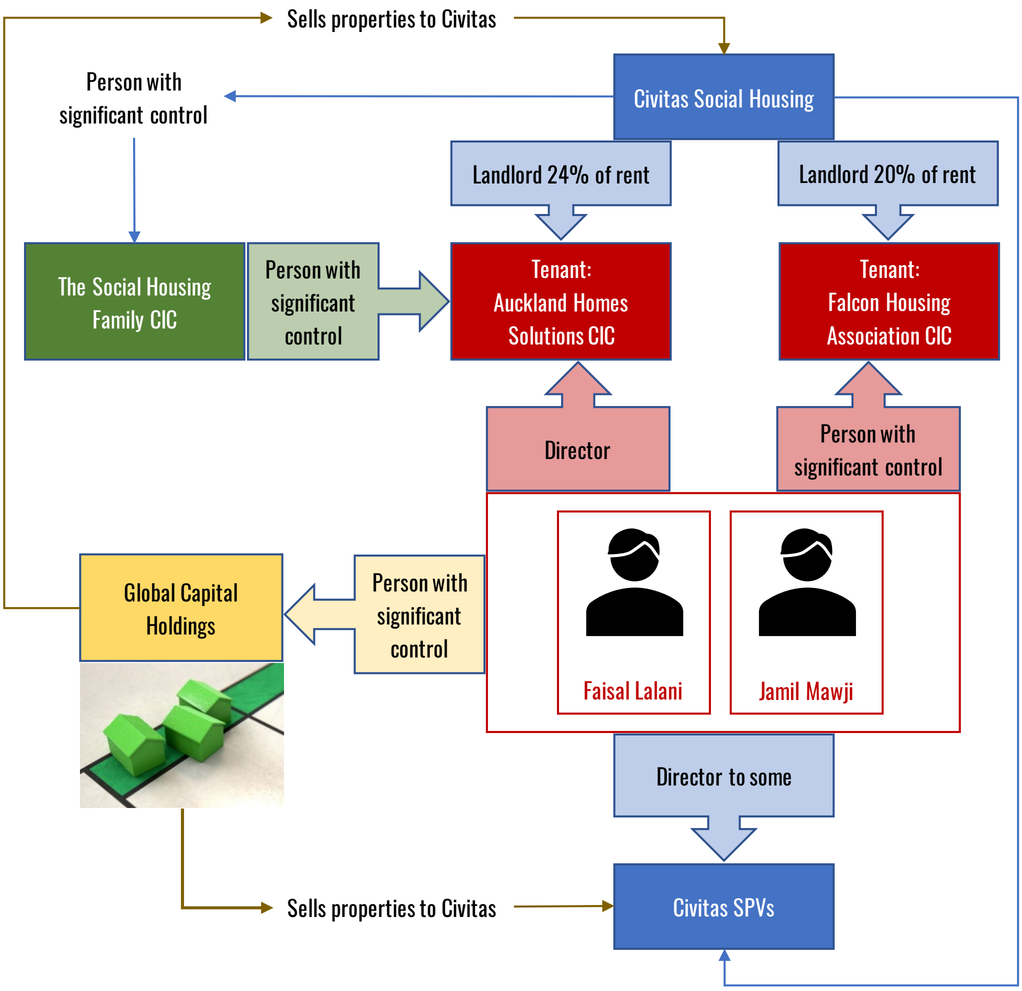

Figure 17 ShadowFall understanding of the relationships between Civitas' two largest tenants by rental income. Source: Company filings, ShadowFall

We note that among your 16 tenants, the majority of these have audited accounts. However, Auckland and Falcon do not have their accounts audited.

Since Falcon is such a significant tenant to Civitas (c. 20% of rent), for Civitas' shareholders' peace of mind as well as its creditors, we believe that it might be worthwhile for Falcon's accounts to be audited. The reason being is that we find its unaudited accounts to be unreliable. For example:

- We believe that numerous financial entries to Falcon's 2020 financial statements have been copied and pasted from prior years. We suppose there is the chance that the financial entries are the same each year, however, on so many instances, it does seem unlikely.
- We find inconsistencies between the annual rental income which Civitas suggests is secured from Falcon, and the annual rental income which Falcon believes it is obligated to pay.

We expand upon this in figures 18 and 19.

FALCON HOUSING ASSOCIATION C.I.C.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)
FOR THE YEAR ENDED 31 MARCH 2019

6 Creditors: amounts falling due within one year

	2019 £	2018 £
Trade creditors	190,286	9,300
Corporation tax	11,853	35,429
Other taxation and social security	-	6,614
Accruals	476,186	494,189
Deferred income	915,155	392,003
	1,593,480	937,535

7 Creditors: amounts falling due after more than one year

	2019 £	2018 £
Deferred income	964,805	640,475
Capex/Void surcharges	427,351	131,821
	1,392,156	772,296

FALCON HOUSING ASSOCIATION C.I.C.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)
FOR THE YEAR ENDED 31 MARCH 2020

6 Creditors: amounts falling due within one year

	2020 £	2019 £
Trade creditors	380,732	190,286
Corporation tax	40,834	11,853
Accruals	1,037,477	1,391,341
Deferred income	915,155	392,003
	2,374,198	1,985,483

7 Creditors: amounts falling due after more than one year

	2020 £	2019 £
Deferred income	1,267,952	640,475
Capex/Void surcharges	427,351	131,821
	1,695,303	772,296

Figure 18 Examples of what we believe to be copy and paste errors within the annual filings for Falcon Housing Association. Source: UK Companies House, Falcon Housing Association CIC

Civitas reports that Falcon accounted for 20.4% and 19.7% of its annual rental income in FY20 and FY21 respectively. This equates to GBP 9.4 million and GBP 9.7 million in annual rental income in FY20 and FY21 respectively which is attributable to Falcon. However, Falcon's financial statements suggest that it has (our bold for emphasis):

> *"At the reporting end date [31 March 2020] the company [Falcon Housing Association] had outstanding commitments for future minimum lease payments under non-cancellable operating leases* ***amounting to approximately £3m per annum****."*

FALCON HOUSING ASSOCIATION C.I.C.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

FOR THE YEAR ENDED 31 MARCH 2020

8 Operating lease commitments

Operating lease payments represent leases of social housing properties for a period of 25 years.

At the reporting end date the company had outstanding commitments for future minimum lease payments under non-cancellable operating leases amounting to approximately £3m per annum.

Figure 19 Falcon Housing reporting of its lease obligations. Source: Company filings, ShadowFall

It is our understanding that properties which Falcon leases from Civitas are held under Civitas SPV1, Civitas SPV22 and Civitas SPV55. These show total future minimum lease receivables under non-cancellable operating leases as follows:

- Civitas SPV1 = GBP 122.7 million
- Civitas SPV22 = GBP 28.4 million
- Civitas SPV55 = GBP 8.8 million

Combined this equates to GBP 159.9 million in total future minimum lease receivables under non-cancellable operating leases. However, as figure 19 above indicates, Falcon suggests that it has outstanding commitments of GBP 3 million pa for 25 years. If this grew at 2% pa (CPI) then we calculate that this would represent an outstanding lease obligation of c. GBP 96.1 million.

In the light of the above, we have several questions which we believe your investors may find helpful to have answered:

21. In the light of the recent findings by the Regulator of Social Housing against Auckland, does Civitas believe it is appropriate that Mr Lalani and Mr Mawji remain as Directors to Auckland?
22. How material are Civitas' property purchases from Global Capital Holdings since its listing?
    If so,
    a. Do any of these properties have either Auckland or Falcon as the Registered Provider tenant?
23. In the light of Falcon suggesting it is only committed to GBP 3 million in lease payments per annum for the next 25 years, does this mean that only 30.9% of the annual rent received by Civitas from Auckland in FY21 was non-cancellable?
24. What is the minimum lease commitment to Civitas from Falcon?