

## London Borough Hammersmith and Fulham Pension Fund

### Ground Rents, Supported Living and Infrastructure Debt Asset Class Overview

September 2020

#### Introduction

This report has been prepared for the Pensions Sub-Committee (“the Sub-Committee”) of the London Borough of Hammersmith & Fulham Pension Fund (“the Fund”).

The purpose of the report is to provide the Sub-Committee with an overview of ground rents, social supported housing and infrastructure debt as investment asset classes. For each asset class the report will cover a summary of the general investment strategy used, the current market and the main benefits alongside the risk/return characteristics of each.

#### Background

At the last Committee meeting, we discussed the M&G Inflation Opportunities Fund (“the IOF”) and the Sub-Committee decided to instruct a full disinvestment from M&G. While the IOF’s income and inflation linkage is important to the overall strategy, the changing allocation of the IOF over the past few years had left the overall Fund overexposed to UK commercial property, in particular long lease.

M&G is expecting to make a full disinvestment payment on 12 October, estimated to be £113m. The initial allocation for the funds will be Ruffer (LCIV Absolute Return Fund) given its downside protection and limited transaction costs. However, the Sub-Committee must reallocate the funds in a more appropriate long term solution and agree a new benchmark asset allocation for the 10% that had been held with M&G.

#### Ground Rents

##### Overview

With any property holding, it is possible to create two levels of ownership: freehold and leasehold. The owner of the freehold maintains ownership of the land and the rights to any properties on that land while the owner of the leasehold acquires the property on a long-term ground lease and consequently has to make regular payments to the freeholder, referred to as ground rents.

Ground leases are typically over 100 years at inception and ground rents are a fraction of the rents a leaseholder may obtain from subletting the property. However, in an environment of low yields, the expected yield on ground leases is attractive (particularly given its security), and if rental increases are linked to inflation, the real yield is high relative to index-linked gilts, making ground leases linked to RPI an attractive inflation hedging investment when compared with traditional liability hedging assets.

Whilst the leaseholder can sell a leasehold property at any time and recover the property’s full sale value, the freeholder still owns the underlying land and therefore has rights over any property, which resides on the land. Consequently, a leaseholder must seek the freeholder’s permission to make any changes to the leasehold property, which may affect the property’s value. Should the leaseholder ever default on their ground rent payments, the freeholder is able to forfeit their ground lease and inherit full ownership of the leasehold property with its higher value. In this way, a ground lease can be viewed as an over-collateralised loan, and this is key to the attractive nature of this investment.

Furthermore, the over-collateralisation means that tenant strength is not as pressing a concern as it is to the leaseholder. The vacant possession value is typically 2 to 4 times greater than the investment value of the ground lease.

## Market Summary

Due to the general low-yield environment seen across investment markets, the demand for previously lower yielding assets such as ground rents has risen in recent years. This has reduced the yield received on purchases of good quality assets, as prices have risen.

In general, due to the size of investment that ground rent funds can target, leases are normally held against commercial property over residential, with funds normally targeting the hotel and holiday park sectors. Given the difficulties that managers face to find good quality assets at attractive prices, it is expected that funds will target other sectors such as healthcare.

## Benefits

- Ground rent investments receive long-term expected cashflows through the rental agreements that are in place with the leaseholder. For some funds, these cashflows can be taken as income distribution and used for pension scheme cashflow management.
- The cashflows received can be inflation linked and rise over time. The inflation linkage is normally through RPI or CPI, with agreements in place to review the rent received with respect to inflation after a few years.
- The returns received generally have low correlation to other return seeking assets.
- If rental income received from the leaseholder stops, the owner of the ground lease is able to take ownership of the leasehold property, which normally has a higher value. This provides security against the risk of default from the other party.

## Risks

- *Counterparty Risk* – A leaseholder may not honour its obligation to pay rent and default on the ground lease agreement. However, as highlighted the owner of the ground lease has security in the form of the leaseholder's property, which it can inherit full ownership of.
- *Valuation Risk* – The value of a ground rent asset is the opinion of the valuers based on several assumptions. Ground rents are largely illiquid and traded infrequently, so valuations can be difficult to benchmark against.
- *Illiquidity Risk* – Ground rent leases can be difficult to buy and sell without suffering a discount. In exceptional circumstances, a fund may limit or suspend trading due to extreme market conditions or high levels of redemptions/withdrawals to protect an investor's funds.

## Return Characteristics

Ground rent assets receive return through both capital appreciation and income from the ground rents themselves. The expected return is generally shown through the yield received on an asset, which accounts for the asset price today and the expected future value based on the cashflows.

Historically, ground rent yields regularly exceeded c. 3% for those with good quality leasehold counterparties, in high-demand sectors and/or prime locations such as the southeast and central London. In recent years, due to increased demand and a decreased supply of good quality assets yields have compressed to between c. 2-3%, which has benefitted those who previously held the asset class, however, has made investment into the asset class more difficult, increasing drawdown times from funds.

## Providers in the market

Manager	Fund	Size	Inception
Aberdeen Standard	Ground Rent Fund	c. £400m	2012
Alpha Real Capital	Index Linked Income Fund	c. £1.7bn	
PGIM	UK Ground Lease Fund	c. £700m	2006
Aviva	REaLM Ground Rent Fund	c. £800m	2011

## Social Supported Housing

### Overview

Social supported housing is purpose built, permanent accommodation for vulnerable individuals with physical and or psychological difficulties, which as a result means they are unable to live and work independently. Subsequently, individuals in this situation receive housing benefits from the central government, with The Care Act (2014) creating a statutory duty for the local government to provide long term, safe and secure accommodation within the community. In these purpose built properties, an annually inflation indexed lease is agreed with a housing association, who are responsible for the administrative tasks (e.g. collecting housing benefits from the tenants) as well as ensuring that care is provided to the tenant.

Previously, these individuals have been homed in accommodation such as hospitals, where they were likely to have shared accommodation with other individuals with similar conditions. However, this is rarely the most appropriate course of action given the fact that privacy and tailored care can be required for each individual. In addition, hospital care is expensive and at times may not be the best solution on a cost basis as well as appropriateness. Mencap<sup>1</sup> estimates that by 2030 around 60,000 individuals will need this specialised form of accommodation, increasing from c. 39,000 in 2015 – based on this there is a large undersupply of purpose built properties in the market currently, and the demand is unlikely to slow down given the lengthy period of time that individuals would need accommodation for.

### Benefits

- The income received is ultimately funded by the UK central government, which clearly represents security. That said, this income is collected via housing associations which themselves carry credit risk. There is also a risk that the government may reduce housing benefits.
- Social Supported Housing has strong and direct ESG credentials, predominantly within a social capacity where providing care and housing to individuals in this situation can have a real and tangible benefit to both the individuals and the wider community.
- Due to a shortage of supply in this type of accommodation, there is strong demand in the market. In addition, the UK government has formally backed some leases for a period (i.e. 10 out of 25 years) to ensure they have uptake.
- The demand for the accommodation is dependent on the number of people who are in need of it, rather than the wider macro-economic and market environment. As such, demand can be seen as relatively uncorrelated to the market.

### Risks

<sup>1</sup> [https://www.mencap.org.uk/sites/default/files/2018-04/2018.052%20Housing%20report\\_FINAL\\_WEB.pdf](https://www.mencap.org.uk/sites/default/files/2018-04/2018.052%20Housing%20report_FINAL_WEB.pdf)

- *Illiquidity Risk* – Due to the bespoke nature of the social supported housing assets it can be difficult to buy and sell without suffering a discount. A fund may also include additional liquidity restrictions to ensure that a fair return is achieved by holding onto assets for an appropriate duration or to restrict trading under certain market conditions.
- *Political Risk* – The return assumptions of an investment are based on the current benefits offered by the government, which could be changed or amended and adversely affect the return on investment.
- *Administrative Risk* – The administration of the social supported housing is carried out by not-for-profit housing associations. If administered poorly, there may be an increased likelihood that they are unable to meet payments or in worst case scenarios go bankrupt.
- *Construction & Development Risk* – Due to the bespoke nature of the assets, they may need to be built or developed. If the construction and/or development of an asset is delayed or requires significant changes, the asset value might be materially affected.
- *Property Market Risk* – The underlying assets might be subject to changes in the wider property market. If property markets undergo a period of distress, the asset values may fall.

## Return Characteristics

The underlying assets are expected to receive a return through both capital appreciation and income from the individual leases. As this is relatively new asset class, historic performance is not yet available. However, funds currently raising are targeting a cash yield of c. 5-6% p.a.

## Providers in the market

Manager	Fund	Size	Inception
Henley IM	SIPUT	c. £400m	2017
Man Group	Community Housing Fund	TBC	2020
Cheyne	Impact Real Estate Trust	£150m	2020
Triplepoint	Social Housing REIT plc	c.£500m	2017
Schroders	Social Housing	c. £50m	2019
PGIM	PGIM Real Estate UK Affordable Housing Fund	TBC	2020

## Infrastructure Debt

### Overview

Infrastructure is the fundamental, physical systems and facilities that are essential to societies and countries in the operation of their economy and provision of services. Historically, infrastructure assets were largely publically owned. However, as time has progressed there has been an increase in ownership from the private sector as governments looked to provide alternative means of encouraging and improving infrastructure investment.

Infrastructure investing can be grouped into two underlying investment types; equity and debt. Infrastructure equity refers to investments that own the asset outright, with the owner expected to manage the planning, construction and operation of the assets. Infrastructure debt refers to investors who provide financing, usually in the form of a loan, to

equity owners, who cannot cover the total cost of the asset. In return, debt investors are usually provided with fixed income alongside the initial capital invested. Infrastructure debt thus reduces the risks associated with equity investment, alongside adding further protection through agreements made with the equity holders such as limiting the counterparty taking out further debt or limiting further drawdowns if the asset falls behind key objectives.

Infrastructure assets are usually characterised by a distinct set of traits that differentiate them from asset classes such as general equity, debt financing or property including high barriers to entry, economies of scale, regulated market and industries, inelastic demand for services and a long-lifespan. These overall characteristics give assets that can produce stable, regular cashflows once operational, with returns that are uncorrelated to the wider market.

Infrastructure assets are normally grouped into a handful of categories relating to their use or service; subsequently each has unique factors that affect the construction, operation and investment into the asset:

- Transportation – covering roads, rail networks, bridges, airports and ports;
- Utility and energy – covering water, power generation and energy distribution networks;
- Communications – covering telecommunication networks; and
- Social – typically covering education, health, recreation and security (e.g. prisons, courts and police stations)

For infrastructure debt, it is important to consider the underlying assets that any loans are made against and the potential risks and headwinds that the owner may face based on current and future economic and regulatory conditions.

## Market Summary

Due to the size of investment needed to build and operate certain infrastructure assets (can easily reach into the £billions), most equity owners will use debt financing. This process of using leverage on the equity side creates the opportunity for greater equity returns.

Globally, private investment into infrastructure can exceed £100bn each year, with funds continually raising capital to meet the ready supply of opportunities. Private infrastructure debt investment has historically been through bank financing, with c. 80-90%<sup>2</sup> continuing through this method over 2016-2018. However, more recently institutional investment has risen, with 19 European based funds raising c. €5.4bn over the two years to the end of 2019.

Recently, at a sector level, renewable infrastructure has seen increased focus as governments and investors become more conscious of the use of non-renewable energy sources and the impact that these have on climate change. In more developed economies, telecommunications investment has also seen a significant rise as customer demand increased internet speeds and upgraded technologies, such as 5G mobile connection.

## Benefits

- Debt agreements with equity holders will receive fixed income repayments that are contractual at expected times. If the equity holder defaults on repayment, the arrangement may include clauses that take effect such as the equity holder not being able to take out any more debt financing or limiting dividend payments until the matter is resolved. The repayments may also include some inflation linkage.
- The underlying assets are likely to be either essential in use or have inelastic demand, meaning that even in the periods of low economic activity, the counterparty should be receiving income and be able to make repayments.
- Of the small amount of defaults that occur, the recovery rate is usually high. In comparison to corporate bonds, the expected loss on infrastructure debt is usually lower.
- UK investment grade infrastructure debt is often linked to inflation (RPI or CPI).

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<sup>2</sup> <https://www.ubs.com/global/en/asset-management/insights/asset-class-research/real-assets/2019/top-infrastructure-trends-for-2020>.

## Risks

- *Counterparty Risk* – The counterparty (usually the infrastructure equity owner) to the debt agreement may default and not meet their obligations. As highlighted investment managers may include clauses that look to limit the occurrence of this and engage with those with high credit ratings.

Similarly, the credit rating of the counterparty may change and affect the price of the bond. Investment managers may therefore look to only invest in counterparties who have higher credit ratings.

- *Valuation Risk* – The value of an infrastructure assets (including debt) is the opinion of the valuers based on several assumptions. Infrastructure assets are largely illiquid and traded infrequently, so valuations can be difficult to benchmark against and know the true market value.
- *Illiquidity Risk* – Infrastructure assets are less liquid than assets traded on public markets. Subsequently, investors may not be able to disinvest quickly without suffering a market discount. Market conditions may also restrict the sale of an asset as there might be no available purchaser.
- *Interest Rate Risk* – The underlying contractual repayments of the debt agreement might be linked to the rate of interest. A change in the level of interest could lead to a material change in valuation of the debt.

## Return Characteristics

The return received on an infrastructure debt investment will be dependent on the counterparty, sector and underlying asset, alongside the seniority of the debt. The majority of the return received over and above corporate bonds comes from the illiquidity premium that infrastructure debt has due it being harder to trade and having long life span compared to regular corporate debt. Accounting for all of this, the return on infrastructure debt usually lies between LIBOR (or equivalent) + 1.5-3.0% p.a. for senior debt.

## Providers in the market

Manager	Fund	Size	Inception	Comments
Macquarie	UK Inflation Linked Infrastructure Debt 2	c. £3bn	Fund 1 in 2011	Fund closed in June and may reopen next year
Allianz	Infrastructure Debt Core	TBC	TBC	European and North America allocations available
Whitehelm Capital	Infrastructure Debt Partners I	c. €500m	2020	Expected final close in summer 2020. Targets defensive, non-cyclical infrastructure

## Conclusion

Each asset class is expected to deliver slightly different returns depending on the precise area of the market. Social supported housing would be expected to deliver returns of c. 4-7% p.a. while ground rents and infrastructure debt would be closer to c. 2-3% p.a. The expected return on the IOF was c. 4% p.a., although it may be questioned whether this level of return was achievable over the next few years.

All three asset classes would provide similar inflation linkage. This would of course limit the funds to UK assets only. While this is common for property and ground rents, this would limit the opportunity set somewhat for infrastructure debt, with fewer transactions in the market.

All three asset classes are also relatively illiquid, although ground rents and social supported housing tend to invest using open ended funds, whereas infrastructure debt would almost certainly be a closed ended fund (usually with 15+ year lock up).

## Recommendation

The Sub-Committee must consider the diversification benefits from each asset class as well as governance requirements of adding further mandates. Given each asset class is relatively illiquid and restricted to UK only assets, there would be a benefit to replacing the IOF allocation with two mandates, for example allocating 5% to each.

While the Fund does not have any direct exposure to any of these asset classes, there is expected to be some infrastructure debt in the Aberdeen Standard Multi Asset Credit Fund. The Fund also has infrastructure equity exposure in c. 7.5% of the total Fund assets, invested with Partners Group and Aviva.

Given this, we feel an asset allocation mix of ground rents and social supported housing would provide the best outcome in terms of risk, return, diversification and liquidity. While both ground rents and social supported living are largely linked to the UK property market, the level of collateralisation in ground rents makes it significantly protected from market falls, while supported living can be protected (to an extent) by securing an element of government backed leases.

## Next steps

The Sub-Committee should consider this proposed allocation, and if agreed, look at possible managers and funds to implement. Given the risk/return characteristics available from social supported housing can vary by strategy type, depending on the specific area of the market it is targeting, we suggest that the exact allocation between both asset classes is considered alongside a review of possible funds. We will also consider the extent of inflation linkage available for different products when considering the allocation split, as well as ultimately selecting the right funds.



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