London Borough of Hammersmith & Fulham

Report to: Pensions Sub Committee

Date: 3 March 2021

Subject: Investment Strategy– Social Housing and Ground Rents

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Summary

This paper and associated Appendix provides the Pensions Sub-Committee with more detailed information on the two asset classes that the Sub-Committee agreed to take forward as potential replacements for the Fund's Inflation Protection allocation, namely:

- Ground Rents
- Supported Social Housing

The attached Appendix from Deloitte provides an analysis of the recent Fund Manager presentations, including a summary of each presentation, responses to questions asked and comments.

Recommendations

The Sub Committee is recommended to select:

1. Alpha Real Capital (ground rents)
2. Man Group (social housing)

Wards Affected: None

LBHF Priorities

Our Priorities	Summary of how this report aligns to the LBHF priorities
• Building shared prosperity	Being an outperforming investor means that as part of the Pension Fund's fiduciary duty, its investments should be able to assist in making a positive financial contribution, sharing prosperity and lessening the financial impact on council tax payers.

Financial Impact

The financial implications of these investments will be continually monitored to ensure that members' pensions are safeguarded.

Legal Implications

None

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Background Papers Used in Preparing This Report

None

Asset Class Review

1. Background

1.1. The Pensions Sub-Committee agreed to terminate the M&G Inflation Protection mandate. This was due to a number of factors but, most notably, the major factor was the over exposure to long lease property that had built up in the portfolio, overlapping with the Fund's exposure to long lease property via Aberdeen Standard Investments.

1.2. Since then, the Fund's investment consultant, Deloitte, has narrowed down a list of prospective inflation protection strategies that warrant further investigation as potential investment alternatives.

1.3. The Sub-Committee agreed at the meeting dated 29 September 2020 that a replacement portfolio should be constructed of diversified commercial ground rents and an allocation to supported social housing.

2. Investment Strategy

2.1. The two investment classes are described in more detail in the sections below.

<u>Ground Rents</u>

2.2 This is investing purely in the freeholds of larger developments such as mixed use commercial sites.

Benefits

- Ground rent investments generate long-term expected cashflows through the rental agreements that are in place with the property leaseholders. In some instances, these cashflows can be taken as income distribution and used for pension scheme cashflow management.

- The cashflows received can be inflation-linked and increase in amount 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 agreed periods of time.

- The returns receivable generally have low correlation to other return seeking assets.

- If rental income receivable from the leaseholder halts, 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, on which it can inherit full ownership.

- 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.

- Reputational Risk: the Fund may be linked reputationally to news reports of recent ground rent scandals involving residential houses. It should be noted that the managers being considered run commercial ground rent portfolios only.

Supported Social Housing

2.3 Investing in purpose built social housing specifically for individuals who may require special care or are unable to live and work independently.

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., ten 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

- 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 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 varied or amended, and adversely affect the return on investment.

- Administrative Risk: the administration of the social supported housing is implemented 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 and 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.

2.4 The attached Appendix describes the current providers in detail and will be discussed at the meeting.

3. Detailed Analysis

3.1. Two potential managers within the ground rent asset class and three potential managers within the social housing asset class were each given ten minutes to present and then took questions from the Sub-Committee and Deloitte. Presenting on ground rent was Alpha Real Capital (ARC) and Aberdeen Standard Investments (ASI). Presenting on social housing was Man Group, Triple Point and Henley.

3.2. A summary of each manager’s presentation, responses to questions, and comments by Deloitte can be seen in Appendix 1.

3.3. On ground rents, the Sub-Committee's initial view was the ARC was better placed to undertake a ground rent mandate on behalf of the fund. Members were concerned by risks in the ASI proposal, including significant concentration risk reference exposure to hotels and airports.

3.4. Regarding social housing, the initial view was to allocate a portion of capital to Man Group and potentially hold back some capital to allocate to Henley at a later date.

3.5. Although Members were very impressed by all the offerings in the social housing asset class and the social impact benefits they bring, Man Group was deemed to have the most robust offering in terms of risk management and the overall portfolio strategy was more attractive.

4. Risk Management Implications

4.1. Risk are outlined in the report and associated Appendix.

5. Other Implications

5.1. None

6. Consultation

6.1. None

List of Appendices:

Appendix 1: EXEMPT LBHF Ground Rents and Supported Living Affordable Housing Manager Selection Notes