Item 3(b)

19th March 2025

Glasgow City Council

Strathclyde Pension Fund Committee

Report by Richard McIndoe, Director of Strathclyde Pension Fund

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Direct Impact Portfolio (DIP)
Investment Proposal – Octopus Affordable Housing Fund

Purpose of Report:

To set out a proposal for an investment of £50m within DIP.

Recommendations:

The Committee is asked to **APPROVE** an investment of £50m in Octopus Affordable Housing Fund by DIP.

Ward No(s): Citywide: ✓

Local member(s) advised: Yes ☐ No ☐ consulted: Yes ☐ No ☐

1 Background

1.1 Portfolio Establishment

In December 2009, the Strathclyde Pension Fund Committee agreed to establish a New Opportunities Portfolio (NOP) with a broad remit to invest in assets for which there was an attractive investment case but to which the then current structure did not provide access.

1.2 Review

The NOP strategy has been subject to 3-yearly reviews with the name changing to the Direct Investment Portfolio in 2015 and again in 2021 to the Direct Impact Portfolio. The most recent review was concluded in November 2024. This made no change to the objectives, structure, risk parameters or governance structure, but did result in increases to the DIP's overall allocation and minimum required investment return and a minor amendment to the definition of the maximum investment size. The Co-Investment Programme was also extended, in conjunction with an increase in the maximum co-investment size.

1.3 Implementation Framework

DIP investment proposals are assessed on their own merits within an agreed implementation framework based on SPF's overall risk-return objectives and specific DIP parameters.

The framework agreed at the 2024 review is summarised below.

Direct Impact Portfolio	
Objectives	Primary objective identical to overall SPF investment objective. Secondary objective of adding value through investments with a positive local, economic or ESG (environmental, social, governance) impact.
Strategy & Structure	In line with SPF risk-return framework but focused on the UK and the Equity, Long Term Enhanced Yield and Short-Term Enhanced Yield asset categories.
Risk and Return	Portfolio benchmark return of **CPI +3% p.a.** Individual risk and return objectives for each investment. Minimum Investment Return (Net IRR) of **6.5%**.
Capacity	Target allocation of **7.5%** of total Fund (based on Net Asset Values). Range of **5%** to **10%** of total Fund.
Investment Size	Target: **£30m** to **£100m** Minimum: **£20m** Maximum: **£250m**
Decision Making	3 stage process with review and satisfactory due diligence by officers, followed by a presentation to the Sounding Board before a proposal is taken to Committee for approval subject to completion of legal documentation.
Monitoring	Includes individual investment reports, participation in advisory boards and a quarterly DIP monitoring report which is reviewed by the Fund's Investment Advisory Panel.
Co-Investment Programme	Existing Co-Investment Programme (CIP) increased to £300m with maximum investment per asset increased to £25m, subject to the CIP investment parameters.

The following proposal has been assessed using this framework and has been reviewed by the SPF Committee Sounding Board.

2 New Investment Proposal

2.1 Key Terms

Name	**Octopus Affordable Housing Fund**
Investment vehicle	English registered private limited partnership
Manager	Octopus Real Estate
Sector	Affordable Housing
Investment objective	To generate resilient, index-linked income and capital appreciation via the creation of a portfolio of UK Affordable Housing assets
Term	Evergreen (no fixed term)
Target size	£300m (Hard Cap £1bn+)
Proposed DIP investment	£50m
Target return	Total Return of 7% p.a. (Net) over rolling 5-year periods / Cash Yield 3.5% p.a.

2.2 Investment Summary

The Octopus Affordable Housing Fund (OAHF or "the fund") seeks to deliver resilient, index-linked income and accompanying capital appreciation by funding the delivery and being a responsible long-term owner of a portfolio of high-quality General Needs and Extra Care (i.e. older persons') Affordable Housing across the UK.

An important differentiating characteristic of the fund will be the relatively strong emphasis placed on the energy efficiency of the homes.

A commitment by DIP of £50m to OAHF is proposed.

Octopus Real Estate (ORE) is a specialist fund manager investing equity and debt finance into the UK commercial and residential real estate (RE) market. Part of the Octopus Group, it has been investing into the RE market for 17 years and will be the fund's manager.

OAHF aims to contribute to addressing two current key issues, namely the UK's structural housing crisis and the current cost of living crisis.

More information on the investment manager is included in **Schedule 1.**

2.3 Investment Rationale

ORE's investment strategy for OAHF is based on its analysis of the Affordable Housing sector in the UK which encompasses: -

- the significant shortage of quality, genuinely Affordable Housing;
- the current cost of living crisis;
- the ageing UK population;

- the geographical distribution of wealth and opportunity across the UK.

Accordingly, the 4 key impact themes underpinning the investment strategy are:

- accelerating the delivery of new, genuinely affordable, quality homes;
- reducing fuel poverty;
- delivering Affordable Housing for older people; and
- supporting levelling-up across the UK.

The fund's assets will either be acquired as i) newly built, standing investments from; or ii) via the funding of the construction of the development pipelines of housing associations (HAs), local authorities (LAs) and/or other third-party developers.

For the past number of years, HAs/LAs have required to allocate ever higher proportions of their budgets to the improvement, refurbishment, safety and energy efficiency of their existing housing stock, which has been to the detriment of the development of new housing projects.

2.4 Investment Management

In respect of OAHF, ORE seeks to work in partnership with regulated HAs/LAs to facilitate the construction of their new housing development pipelines, primarily through "forward commitment" (acquiring the properties on a "turnkey" basis on full completion) or less often via "forward funding" (acquiring the sites at a very early stage of the construction phase and funding the HAs/LAs to manage the construction process to completion). In either case, following completion the fund will partner with the HA/LA concerned in the management, maintenance and operation of the properties.

OAHF will own the affordable homes through its subsidiary, NewArch, a Registered Provider (RP) of social housing, which is regulated by the Regulator of Social Housing (RSH).

This has several benefits, including ensuring that the fund's housing activities will be subject to full, independent regulatory oversight, while also enabling the fund to acquire newly constructed housing under Section 106 provisions. This is the obligation on housebuilders to construct a specified number of Affordable Homes as part of the relevant planning consent for a given site, which they are then required to sell to an RP. It also allows the fund to obtain housing grants from housing bodies such as Homes England, and to employ a direct-let model with the day-to-day management of the properties being undertaken by approved HA/LA partners under long-term management agreements or leases.

The fund, via NewArch, may therefore acquire newly constructed housing stock from HAs/LAs as detailed above; via Section 106 purchases; or alternatively through the acquisition of parts of larger housing developments direct from housebuilders, where material discounts make this attractive. Under any of these scenarios however, the fund will not assume planning risk.

2.5 Investments

The fund is targeting a portfolio with: -

- at least 50% (likely to be materially higher) in General Needs rented homes, with the remainder in intermediate tenures (e.g. Intermediate Rent, Shared Ownership, Rent to Buy etc);
- up to 35% in Extra Care (i.e. older-persons' Affordable Homes);
- up to 15% in private rented units;
- up to 10% in non-residential (i.e. commercial) real estate.

All homes will be benchmarked against appropriate industry-standard measures of quality, including sustainability standards.

One of the fund's core aims is to materially reduce the effects of fuel poverty in its housing portfolio, with all homes requiring a minimum energy efficiency rating of EPC B (with a target of EPC A). An EPC rating of E is currently required in the UK for rented homes (due to rise to C by 2030).

By way of context, the average UK home has a D rating, with an annual average energy bill of £2,340, whereas the typical newly built UK home has a B rating and an average bill of £1,039. Homes with an A rating will have average bills materially lower than this, and in some cases, potentially even zero.

2.6 Other Investors

OAHF has secured commitments of £242.5m from 7 institutional investors, 6 of which (representing £230m of the total) are UK LGPS funds (or pools).

2.7 Risks

The main risks of the proposed investment in OAHF are considered to be as follows:

- Site Origination Risk;
- Construction Risk;
- Letting Risk.

A summary of risks and key mitigants is contained in **Schedule 2**.

2.8 Projected Return

The fund has a target return expressed as a Total Return of 7% p.a. (net), annualised over 5-year rolling periods and a Cash Yield of 3.5% p.a., with effect from the operational phase of the projects (i.e. once completed & let).

This is considered to be a satisfactory target return for the perceived risk of the Affordable Housing sector as represented by the fund's strategy.

2.9 Exit

The fund is an evergreen or open-ended investment vehicle which means that it has no fixed maturity date, and so additional commitments may be raised and deployed throughout the fund's life. A liquidity mechanism is provided within the fund's strategy following a minimum period of 4 years, although this is not guaranteed and will be subject to market conditions.

2.10 Fees

The Management Fee is structured into a one-off element on the acquisition of each development in addition to an ongoing element. This structure is typical of DIP's experience of the Affordable Housing sector. The ongoing element of the fee incorporates a modest discount based on the size of DIP's proposed commitment. A Carried Interest (or performance fee) however is not applicable.

The Management Fee is therefore considered satisfactory in the context of the sector, while it is relatively unusual for carried interest not to apply.

2.11 ESG and Impact

Octopus Group integrates ESG and Impact considerations across all its business activities and investment products, in line with its Responsible Investment policy and overseen by its Responsible Investment Committee. The latter is comprised of the Group's most senior executives to ensure accountability and compliance with the policy.

A summary of the fund's ESG and Impact factors is contained in **Schedule 3.**

2.12 Investment Size and Cash Requirements

SPF Fund value at 31st December 2024	£31,206m
DIP allocation (target 7.5% of main fund) NAV	£ 2,340m
Current DIP NAV	£ 1,607m
NAV Range (Lower) 5%	£ 1,560m
NAV Range (Upper) 10%	£ 3,121m

2.13 Investment Strategy

The proposed investment falls within the Property sector and therefore the Fund's Long Term Enhanced Yield allocation. Affordable Housing is a key area of investment focus for DIP.

Allocations following this investment based on SPF values at 31st December 2024 and total DIP commitments to Property would be as follows: -

Property, £ in DIP	£420m
Property, % in DIP	18%
Property (DIP), % of Total Fund	1.3%
LTEY, % Total Fund (target 21.0%)	19%

3 Policy and Resource Implications

Resource Implications:

Financial: Investment of £50m to be drawn as required. Fee structure is considered to be in line with the market.

Legal:	The investment will be subject to satisfactory completion of due diligence, including review and execution of appropriate legal documentation.
Personnel:	None
Procurement:	None
Council Strategic Plan:	SPF supports the mission: ***to enable staff to deliver essential services in a sustainable, innovative and efficient way for our communities***. The LGPS is one of the key benefits which enables the Council to recruit and retain staff.
Equality and Socio-Economic Impacts:	
Does the proposal support the Council's Equality Outcomes 2021-25? Please specify.	Equalities issues are addressed in the Fund's responsible investment policy.
What are the potential equality impacts as a result of this report?	None
Please highlight if the policy/proposal will help address socio-economic disadvantage.	By definition, Affordable Housing projects benefit key workers (amongst others) who would otherwise be unable to afford private housing (purchase or rent) while the fund's focus on lower energy bills also assists with cost of living challenges.
Climate Impacts:	
Does the proposal support any Climate Plan actions? Please specify:	More energy efficient housing contributes to an overall reduction in carbon emissions.
What are the potential climate impacts as a result of this proposal?	The UK's property heating/energy efficiency sector currently offers significant potential decarbonisation opportunities, to which the proposal seeks to contribute.
Will the proposal contribute to	As noted above.

Glasgow's net zero carbon target?	
Privacy and Data Protection Impacts:	To be fully provided for in the legal documentation for the proposed investment.
Are there any potential data protection impacts as a result of this report Y/N	N
If Yes, please confirm that a Data Protection Impact Assessment (DPIA) has been carried out	n/a

4 Recommendations

The Committee is asked to **APPROVE** an investment of £50m in Octopus Affordable Housing Fund by DIP.

Schedule 1 Investment Manager: Octopus Real Estate
Schedule 2 Investment Specific Risks
Schedule 3 Impact and ESG

Schedule 1

Investment Manager: Octopus Real Estate

Octopus Real Estate (ORE) is a division of Octopus Investments Ltd and part of the Octopus Group, an independent, multi-strategy, predominantly UK-focused investment management business with Assets Under Management (AUM) of £10.5bn (Sept 2024). Established in 2000, the Octopus Group is majority owned by its founders and 900+ employees. It invests in real estate, energy infrastructure, healthcare real estate, venture capital, smaller company investment, and fund of fund investing, in both the public and private markets.

The Octopus Group has a long-term outlook focused on creating value in selected markets. Its investment principles have been adopted across business lines and are focused on markets that have been neglected or with disenfranchised stakeholders. As a result of this Octopus seeks to gain a deep understanding of a few select markets to identify opportunities and develop businesses, investments and solutions to reshape these markets.

ORE is based in offices in London and Manchester and is a specialist RE fund manager investing in the UK market and providing debt finance for UK commercial and residential property. It has a 17-year track record, 90 employees and AUM of £3.8bn (Sept 2024) with 6 investment strategies across debt and equity. The ORE division comprises sub-teams including care homes, retirement living, residential, commercial & development debt and Affordable Housing.

ORE has extensive experience in being a long-term investor and specialist landlord of social care assets, including in UK elderly and specialist care homes (92 nursing homes), retirement living (2 institutionally funded investment strategies) & residential development assets, as well as a number of commercial real estate debt funds.

The 3 key individuals managing the OAHF fund are Jack Burnham, Kevin Beirne and Peter Merchant, all of whom have extensive social housing experience, as well as in running other long-term impact focused investments.

Jack Burnham (Head of Affordable Housing) joined ORE in 2022 from a HA with over 5,000 homes, where he spent 5 years as Executive Director of Growth & Investment, leading the growth programme named as the 3rd fastest growing HA in 2022 with over 1,000 units under development.

Octopus Group's energy expertise provides a unique proposition for HA/LA partners in terms of retrofitting existing homes as well as the energy strategy on new builds, enabling additional energy-related, cost of living benefits outwith normal investment parameters.

Investment Specific Risks

Site Origination Risk
The fund's strategy is predicated on the development of fully consented housing projects by their HA/LA (and/or other third party) owners currently unable to construct them due to financial constraints, or the acquisitions of completed housing stock from housebuilders either under Section 106 provisions or on discounted portfolio bases. In any of these scenarios the main constraint is investment capital rather than the scarcity of development opportunities and so the current risk of failing to identify sufficient development opportunities is considered low.

Construction Risk
For those developments where the housing stock won't be acquired outright on final completion (i.e. forward funded developments which are expected to represent a minority of projects), the HA/LA or third-party vendor will assume the construction risk. For forward funded developments however, it is not possible for the fund to fully mitigate the potential financial risk of the insolvency of the contractor concerned. While the HA/LA developer and OAHF (as funder) will be protected at least to an extent by various mitigants including step-in rights, collateral warranties, performance guarantees and contract retentions etc., much will still depend on the financial circumstances of the development at the time.

Strong, reputable, national construction contractors will be engaged by the HA/LA developers in agreement with the fund, on fixed price building contracts (with cost over-runs, delays and liquidated damages risk lying with the contractor) to allow for an appropriate level of financial protection in the event of contractor failure. As forward funding lenders, the fund would monitor the construction process and will advance funding on an arrears basis on a formal development valuation basis.

The risk of contractors failing can never be eliminated. In this scenario the developer will require to engage replacement contractors using the performance bonds, guarantees, contract retentions and other measures to cover the extra financial costs.

Letting Risk
The sheer scale of the current imbalance between supply and demand of housing in general and Affordable Housing in particular, is such that the risk of not letting the completed housing units is considered very low indeed.

Impact and ESG

The OAHF has a comprehensive Responsible Investment (RI) Policy which sets out the fund's approach to identifying and managing ESG risks and delivering impact.

The RI policy is supplemented by a range of other related policies which will apply to the fund including: -

- The Impact Framework defines the social impact associated with the fund's investments and includes KPIs linked to the Sustainability Reporting Standard for Social Housing. This will be formally reviewed annually by The Good Economy, a leading independent social impact consultancy and will incorporate a review of the fund's ESG performance against its 4 key impact themes (see Section 2.3);

- The Quality Book governs the quality of assets to ensure their compliance with the fund's high minimum standards, as well as to measure the impact credentials of new investments;

- The fund's long-term Asset Management Strategy serves to ensure that Octopus manages and maintains the fund's assets to a high-quality standard, with the ultimate aim of operating to a "Net Zero" basis;

- The fund's Social Housing Governance, Regulation and Oversight Policy sets out the fund's approach to meet the regulatory requirements for NewArch, the fund's RP which is regulated by the RSH;

- The fund will only be partnering with HAs which are also regulated by the RSH for the ongoing management of the housing portfolio. These partnerships are key to the development of new stock and the successful day-to-day management of the homes over the longer term;

- In respect of sustainability, all properties will be built to EPC B standard or higher and where possible the Manager will seek to implement the Octopus Energy (the energy generation and supply division of the group) Zero Bills strategy under which the fund's houses, through a combination of energy efficiency measures, solar panels, low carbon/renewable energy power/heat sources, battery & electric vehicle technology etc, will facilitate materially lower or potentially even zero energy bills for the occupiers.

Octopus has been a signatory to the UN supported Principles of Responsible Investment (UNPRI) since 2020 and has also been awarded the status of a Certified B-Corporation since 2021. The latter recognises businesses that meet the highest standards of verified social and environmental performance, public transparency and legal accountability to balance profit and purpose. In becoming a B-Corp, Octopus changed its constitution so that every decision made considers the interests of their employees, communities, customers, shareholders and the environment.