Item 4(b)

5th June 2019

Glasgow City Council

Strathclyde Pension Fund Committee

Report by Director of Strathclyde Pension Fund

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Direct Investment Portfolio (DIP)
Investment Proposal – Places for People Scottish Mid-Market Rental Fund

Purpose of Report:

To set out a proposal for an investment of £25m within the Direct Investment Portfolio.

Recommendations:

The Committee is asked to **APPROVE** an investment of £25m in the Places for People Scottish Mid-Market Rental Fund by the Direct Investment Portfolio.

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 current structure did not provide access.

1.2 Review

The NOP strategy was reviewed in 2012 and in 2015. It was re-branded as the Direct Investment Portfolio (DIP) in 2015. The most recent review of the DIP strategy and operating arrangements was concluded in December 2018.

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 2018 review is summarised below.

Direct Investment 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 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.
Capacity	Target allocation of **5%** of total Fund (based on Net Asset Values). Range of **2.5**% to **7.5%** of total Fund.
Investment Size	Target: **£20m** to **£100m** Minimum: **£10m** Maximum: greater of **£200m** or **1%** of Total Fund Value.
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

The following proposal has been assessed using this framework and is considered appropriate for recommendation to the Committee.

2 New Investment Proposal

2.1 Key Terms

Name	**Places for People ("PfP") Scottish Mid-Market Rental Fund**
Investment vehicle	Scottish limited partnership
Manager	PfP Capital Ltd
Sector	Affordable residential accommodation
Investment objective	To develop 1,000+ purpose built, affordable residential units for rent in Scotland
Term	30 years
Target size	£160m (inclusive of a £47.5m Scot Govt loan)
Proposed DIP investment	£25m
Target return	Internal Rate of Return (IRR) of 5-7% (Net) and Yield of 4-6% p.a. (Net)

2.2 Investment Summary

The PfP Scottish Mid-Market Rental (SMMR) Fund aims to develop a portfolio of 1,000+ quality, affordable homes for the mid-market rental sector in Scotland's main cities within the next two years to deliver index-linked yield and long term capital growth to investors.

PfP is a not for profit organisation with a strong social purpose, which utilises commercial business methods to deliver positive social outcomes.

An investment of £25m by the Direct Investment Portfolio in the PfP SMMR Fund is proposed.

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

2.3 Investment Rationale

The supply of housing in Scotland remains at historically low levels, with estimates indicating that 23,000 new homes are required each year to meet its housing needs, driven by population growth & smaller average household sizes. New home completion rates however have fallen materially below this level since their peak in 2007 with the balance of completions also increasingly shifting towards the private sector from the more traditional public sector owners (local authorities & housing associations).

Demand for MMR (or "affordable") homes in particular has significantly outstripped supply, particularly in city locations. A recent MMR development in Edinburgh attracted 3,000+ applications for 138 available units and this supply/demand imbalance is replicated in all the major urban areas. In 2012 Glasgow City Council estimated the size of the city's MMR market at over 35,000.

MMR properties are affordable rental homes where rent is set below an area's average private sector rate, to cater for a large section of the Scottish population which face three main challenges:-

- not being able to afford private sector rents;
- not being able to save a large deposit for a first time home purchase;
- not qualifying for social housing because of their income levels.

MMR properties are therefore aimed at this segment of the population who are typically (but not exclusively) aged between 21 & 45; earn between £20k-£30k p.a. and include keyworkers or young professionals who may either be unable to afford to buy, or alternatively choose to rent for reasons of flexibility and convenience, however struggle to afford private rental rates.

SG has made a commitment to deliver over 50,000 affordable homes by March 2021, of which 35,000 will be for social rent and provided through the housing association sector.

The PfP SMMR Fund will be an important element of this commitment with the aim of delivering 1,000+ affordable units for long term rental in Scotland within 2 years. This will be undertaken in developments of up to c. 150 units, mainly in the major urban areas (Glasgow, Edinburgh, Aberdeen and Dundee), and will enable investors to benefit from the index-linked net operating income and value of the properties over the Fund’s 30 year term.

The Scottish Government (SG) has formally committed to provide the SMMR Fund with a long term loan of £47.5m to assist with the funding of the assets.

2.4 SMMR Fund Description

The Fund is being established to invest in a mix of houses and smaller apartment blocks across Scotland with the overall objective of delivering a diversified portfolio with long-term income and the opportunity for capital growth.

Detailed objectives are:-

- to identify potential development sites by assessing the target market, location, size, type of housing and affordability;
- to develop new MMR properties (of up to 150 units); in close proximity to similar residential housing stock; in areas of expected population / economic growth; and within commuting distance of Scotland’s main cities;
- to invest in both family homes and low rise apartments;
- to acquire sites with planning consent on either a forward funding basis (90%+) where the site is acquired pre-construction and the Fund finances the construction of the homes by the seller/developer); or on a forward commit basis (10%) where the Fund acquires the property on completion (or “turnkey”) basis without providing funding;
- to develop where it believes there is the capacity for both rents and house prices to increase over time.

The SG loan is being provided on favourable terms as part of their desire to explore innovative finance models for new affordable housing. It has been provided subject to the funds being used to develop affordable homes for rent by MMR qualifying individuals/families, in accordance with SG's Public Service Obligations (PSO).

The PSO stipulate:

- the target tenant profile;
- the maximum starting rent levels (c. 60%-80% of the average private sector rent for each type/size of home in each region, but based on the SG's Broad Rental Market Area (BRMA) mechanism on which Local Housing Allowances are set); and
- the maximum annual rent increase, which is limited to CPI.

Castle Rock Edinvar, a PfP Group housing association, has committed £10m to the Fund. The completed homes will be managed (marketing, letting, deposits, repairs & maintenance etc) by Touchstone, PfP's inhouse property management co. Touchstone currently manages over 20,000 properties.

The SMMR Fund currently has 7 developments in its pipeline comprising a total of 825 units.

Sites are in Glasgow (2 projects), Edinburgh (3), East Lothian & Paisley (1 each). These have either been:

- acquired (2 in i) Paisley & ii) Oxgangs/Edinburgh);
- in the legal process (3); or
- at Heads of Terms/Agreement in Principle stage (2).

A further 7 sites (comprising a total of 492 units) are currently under discussion.

2.5 Investment Specific Risks

The main risks of the proposed investment in the PfP SMMR Fund are considered to be:-

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

A discussion of investment specific risks and key mitigants is contained in **Schedule 2**.

2.6 Projected Return

The Fund is targeting a return of 5-7% IRR (Net) and a cash yield of 4-6% p.a.

The investment return is towards the lower end of the range of returns sought by DIP and for this reason, KPMG were engaged to review the Fund's financial projections, targeted investment return, revenue and cost assumptions and key financial sensitivities as additional re-assurance that the targeted returns are reasonable and achievable. KPMG's draft report supports the assumptions used by PfP and the projected returns of the Fund.

KPMG highlighted inflation / CPI as the key sensitivity affecting the Fund's targeted return. In the event that CPI is lower than projected, the Fund's IRR will be lower (and vice versa). Given that SPF's pension liabilities are all CPI-linked, this provides an effective hedge.

2.7 Exit

The term of the fund is 30 years at the end of which the intention is for the assets to be sold on an affordable homes basis. The nature of the exit will however be determined in conjunction with the investors at the time.

2.8 Fees

A management fee based on the Gross Asset Value (GAV) of the Fund applies, in addition to a property management fee in respect of the cost of property management services provided by PfP Group's subsidiary, Touchstone. KPMG confirmed the applicable rate for the latter was not unreasonable for the nature & extent of the services to be provided.

A performance fee based on the *real* cash yield distributed to investors (i.e. after adjusting for CPI) in excess of a benchmark rate also applies.

At the end of the Fund's 30-year life, an Exit Fee will apply to align PfP with the investors in optimising the realisation price of the assets (although still on an affordable homes basis).

The Fund's fee structure reflects the nature of the residential / rented assets being developed and managed on the investors' behalf on a long term basis.

2.9 Environmental, Social and Governance Issues

PfP is a not for profit organization with a strong social purpose. It is driven by both commercial and social objectives with all profits reinvested in the business. As one of the largest managers and developers of private and affordable housing in the UK, it aims to be the most socially responsible asset management company in the housing sector.

2.10 Investment Size and Cash Requirements

SPF Fund value at 31st March 2019	£21.9bn
DIP allocation (target 5% of main fund) NAV	£1,095m
Current DIP NAV	£ 724m
Headroom v NAV	**£ 371m**

2.11 Investment Strategy

The proposed investment falls within the real estate sector and therefore the Fund's long term enhanced yield allocation (LTEY). Allocations following this investment, based on Fund values at 31st March 2019 and total DIP commitments to real estate, would be as follows:

Real Estate, £ in DIP	£75m
Real Estate, % in DIP	6.9%
This investment, % Total Fund	0.1%
LTEY, % Total Fund (target 20%)	15.9%
Limited partnership, % Total Fund (maximum 30%)	12.4%

3 Policy and Resource Implications

Financial: Investment of £25m to be drawn as required. Overall the fees are in line with 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: Not applicable.

Equality and Socio-Economic Impacts:

Does the proposal support the Council's Equality Outcomes 2017-22 Equalities issues are addressed in the Fund's responsible investment policy.

What are the potential equality impacts as a result of this report? No specific impact from this proposal.

Please highlight if the policy/proposal will help address socio economic disadvantage.

Sustainability Impacts:

Environmental:	See section 2.9
Social, including Article 19 opportunities:	See section 2.9
Economic:	See section 2.9

Privacy and Data Protection impacts:	To be fully provided for in the legal documentation for the proposed investment.

4 Recommendation

The Committee is asked to **APPROVE** an investment of £25m in the Places for People Scottish Mid-Market Rental Fund by the Direct Investment Portfolio.

Schedule 1

Investment Manager: Places for People ("PfP")

PfP is one of the largest property and leisure management, development and regeneration businesses in the UK with 11,500 employees. It is a not for profit organisation with a strong social purpose which uses business practices to deliver positive social outcomes.

The PfP Group owns or manages over 200,000 residential properties (including 6,200 in Scotland and 1,500 MMR homes), has 19,000 homes in its development pipeline and operates 116 leisure facilities, with total group assets of £4.5bn and turnover of £754m (FY 2017/18). It provides employment and training opportunities, supports new and existing businesses, provides financial products and specialist care and support services and serves over 500,000 customers in the UK.

The key personnel of the PfP SMMR Fund are Chris Jones (Managing Director, PfP Capital) and William Kyle (Fund Manager).

Jones has 25 years of experience in real estate finance and senior management. He is responsible for governance, compliance, regulatory and ESG policies/practices and for setting and maintaining the strategic direction of PfP Capital.

Kyle is a planning and development surveyor and member of the Royal Institution of Chartered Surveyors. He is experienced in all aspects of land acquisition and planning for residential development and was previously Development Director at Sigma Capital, where he was responsible for the development of family housing for rent and leading a development team in the origination, assessment and acquisition of suitable development sites. He has also worked for both national volume and luxury regional housebuilders with a focus on the acquisition and planning processes as well as in the asset management of a portfolio of development assets throughout Scotland and Northern England for a major UK bank.

Jones / Kyle are supported by a Board comprising 6 other Directors (non-executives and members of the Fund's i) Investment and ii) Risk & Compliance Committees).

The Board comprises individuals with a combined 180 years of senior experience and includes chairpersons of publicly listed companies, a director of the Institute of Directors, a Managing Director of Deutsche Bank, a member of the Council of Mortgage Lenders and the EU Mortgage Finance Agency, fund managers (including Mercury Fund Management) and a Barrister/QC of 32 years' experience.

Investment Specific Risks

Property Development Risk

PfP anticipates that the construction of over 90% of its developments will be undertaken by the sellers on a forward funding basis where the seller/developer takes the construction risk, not the SMMR Fund. The balance are expected to be on a "turnkey" basis where the Fund acquires the property post-completion without providing pre-funding. No planning risk will be assumed under either scenario.

Site Origination Risk

With 7 developments comprising 825 units currently either acquired, in the legal process or at agreement in principle stage and a further 7 developments (representing an additional 492 units) under discussion, the risk of failing to identify sufficient development sites to achieve the targeted 1,000 units is considered low.

Construction Risk

The PfP team has extensive experience in the property development process from site identification, planning, acquisition, though to development and construction.

Strong, reputable national construction contractors will be engaged on fixed price building contracts (cost over-runs being for the contractor's account) and incorporating performance bonds and/or parent company guarantees as applicable, to ensure an appropriate level of financial surety available in the event of contractor failure.

PfP will monitor the construction process and where funding the development will do so in arrears, on a formal development valuation basis with penalties for delays.

The risk of contractors failing cannot be eliminated. In such a scenario however, PfP would require to replace the contractors using the performance bonds, guarantees, contract retentions and other measures to cover the extra financial costs.

Letting Risk

While most of the developments will be for 100 units or less (maximum 150), the expected demand for affordable housing is such that the risk of not letting the units at the discounted/affordable rates (discounted compared with private rentals in the respective area) is also considered low.