



Glasgow City Council

Strathclyde Pension Fund Committee

Report by Director of Strathclyde Pension Fund

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Item 4(a)

5th June 2019

**Direct Investment Portfolio (DIP)
Investment Proposal – Legal & General UK Build to Rent Fund**

Purpose of Report:

To set out a proposal for an investment of £75m within the Direct Investment Portfolio.

Recommendations:

The Committee is asked to **APPROVE** an investment of £75m in the Legal & General UK Build to Rent Fund by the Direct Investment Portfolio.

Ward No(s):

Citywide: ✓

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

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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	Legal & General UK Build to Rent Fund
Investment vehicle	English limited partnership
Manager	L&G Property Partners (Operator) Ltd
Sector	Private rented residential accommodation
Investment objective	To develop a portfolio of purpose-built, private rented residential accommodation in the UK
Term	Open-ended from January 2023, when L&G will assist in facilitating realisations as required by investors (with a 12 month notice period)
Target size	Fund is targeting AUM of £3bn by 2023
Proposed DIP investment	£75m
Target return	Development Phase – Internal Rate of Return (IRR) of 10%+ (Net) per asset; Operational Phase – Total Return of 6-10% p.a. (Net) and Net Yield of 3-5% p.a.

2.2 Investment Summary

The Legal & General (“L&G”) UK Build to Rent (“BtR”) Fund aims to develop a portfolio of purpose-built, private rented residential accommodation in the UK, to hold for the long term with a view to generating stable cash yields and capital preservation for investors.

The Fund currently has 12 projects at various stages of development in cities across the UK. These represent over 3,700 housing units in total.

An investment of £75m by the Direct Investment Portfolio in the L&G UK BtR Fund is proposed.

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

2.3 Investment Rationale

The chronic shortage of housing in the UK is widely acknowledged with the current level of new housing development failing to keep up with current demand, much less making inroads into the accumulated shortfall.

The combination of strong demand for housing from population growth, reductions in the size of average households, the inability of young people in particular in getting onto the property ladder and the inadequate level of new housing completions has led to increased demand in the private rental sector and consequently low vacancy levels.

This supply / demand imbalance has resulted in a high level of stability in rental income with the potential for above inflation rental growth over the long term, a trend which has been seen in a number of other countries such as the US, Germany and the Netherlands. In the UK just 1% of private rented housing stock is owned by institutions, compared with the USA (13%), Germany (17%), Switzerland (23%) and the Netherlands (37%).

The UK residential, rental market is extremely fragmented with the majority of UK private rented housing being owned by private (or “buy-to-let”) landlords. Of the entire UK private rented housing stock, 70% is owned by landlords with fewer than 10 properties (of this 40% of the stock is owned by individuals with just one property). Many of these private landlords are seeking to exit the market due to changes in taxation and the absence of economies of scale, which has improved the relative economics of institutional ownership.

L&G anticipates the pattern of relatively strong risk-adjusted returns in the UK residential property market to continue and that rents will continue to grow ahead of inflation. The current fragmented sector also presents the opportunity to introduce higher standards of design and operational management, which in turn is anticipated to support above average investment returns.

2.4 BtR Fund Description

During the first five years of the BtR fund it will be largely development led as it builds up a portfolio of completed development projects. The fund is targeting a portfolio of properties with Assets Under Management (“AUM”) of £3bn by 2023.

The 12 projects currently in progress across the UK are at various stages of development and represent a combined total of over 3,700 housing units and total development costs of c. £1.3bn.

Of these projects:

- 2 are completed and either fully let (Salford - 225 units) or partially let (Bath - 171);
- 3 are in construction and anticipated to be in the letting phase by the end of 2019, namely Manchester (350); Birmingham (220) & Walthamstow (479);
- a further 4 are in earlier stages of construction (Bristol, Leeds, Salford II and Croyden with a combined 1,073 units); and
- 3 more are either in the planning or legal process (Brighton, Glasgow and Woolwich with a combined total of 1,234 units).

These 12 projects are supported by a further active pipeline currently comprising 12 other developments, representing a further 3,800 units. The Fund anticipates constructing c. 2,000 units p.a.

As the relative proportion of development projects decreases and operational assets increase, the Fund will focus on maximizing distributable cashflow through the ongoing management of the portfolio of fully let assets. It will however continue to develop new assets to improve diversification, although this will be limited to 15% of the Net Asset Value of the Fund.

The development of each asset is undertaken through a separate limited partnership vehicle, Access Development LP (“Access”).

Access is a partnership between L&G and PGGM, a Dutch co-operative pension fund which provides asset management, pension fund management and pensions policy advisory services, with AUM of over £183bn. PGGM

additionally has invested in Build to Rent housing for over 40 years with c. £3bn of residential investment assets in the Netherlands and the US.

L&G and PGGM have each invested £200m into Access. PGGM will convert its investment into the BtR Fund when the development phase ends.

The BtR Fund has a co-investment right to buy a one-third share of any qualifying development undertaken by Access. Once an asset has been completed and fully let (i.e. “stabilised”) the BtR Fund has a pre-emption right to acquire the two-thirds stake not already owned, at the then market value of the completed development. Following the sale of their stakes in a completed development, L&G and PGGM will then roll their capital (and development gains) into the next project.

In selecting potential development sites, the Manager seeks to identify major UK cities with long-term supply / demand imbalances and a particular focus on population demographics, forecasted population / economic growth, population density and historical / projected supply of residential accommodation.

When a city has been selected, the focus then turns to sites with suitable characteristics in respect of proximity and/or commuting times to centres of employment, transport hubs, amenities, shopping and schools etc, with the fund having a preference for regeneration sites.

The BtR Fund will target developments offering a minimum of 150 units in order to optimise design factors and economies of scale.

Across the portfolio of developments the average proportion of affordable housing units is c. 12%. This is driven by the Section 106 conditions stipulated by the planning authorities in the respective cities.

Once operational the BtR Fund will appoint experienced property service managers to ensure a high and consistent level of service to the residents aimed at maximizing occupancy and net operating income. They will be tasked with delivering exceptional service to residents to reduce tenant turnover and voids.

Residents will be offered leases of between 6 months and 5 years, providing flexibility and security of tenure, with rents for longer leases being increased in line with inflation. The initial letting strategy of each completed asset will require to carefully manage the volume of units being released at any one time to avoid the risk of distorting the respective local markets.

2.5 Investment Specific Risks

The main risks of the proposed investment in the L&G BtR Fund are considered to be as follows:-

- Property Development Risk
- Construction Risk
- Letting Risk

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

2.6 Projected Return

The Access Fund targets a net IRR of 10%+ during the development and construction phase of each individual project. As one-third co-investors, an equivalent proportion of any development gain will accrue to the BtR Fund.

Following stabilization, when the assets are fully operational and the BtR fund has acquired full ownership, the target Total Return is 6-10% p.a. (Net) with a target Net Yield of 3-5% p.a.

2.7 Exit

The BtR Fund is designed to be a long term, open-ended fund, although initially it will be closed-ended until January 2023, at which time the Manager will seek to facilitate redemptions and investment realisations as required by investors.

2.8 Fees

The fee structure for this residential investment opportunity encompasses separate elements relating to the development (the Access partnership) and operational (BtR partnership) phases of the individual assets.

The fees for the development phase are structured on the basis of either a project *management* fee, or a (lower) project *monitoring* fee, according to whether the development is managed inhouse by L&G, or by a third party (and monitored by L&G) respectively. This is additional to a performance related fee based on any asset valuation gain resulting from the development phase, which aligns the interests of L&G and the investors in Access.

In respect of the operational phase, a relatively modest management fee applies, plus a property management fee which mainly relates to the ongoing management of the property, letting activities etc.

Overall the fees are considered reasonable and in line with DIP expectations.

2.9 Environmental Social and Governance Issues

As one of the UK's largest landlords, L&G acknowledges its responsibility to exceed industry standards in incorporating ESG factors into the design, construction and management of their developments.

L&G participates in the annual Global Real Estate Sustainability Benchmark (GRESB) and has achieved the highest possible score for all 13 of its funds in each of the past four years. L&G is also a signatory to the UNPRI (UN Principles for Responsible Investment).

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	0.3%
LTEY, % Total Fund (target 20%)	15.9%
Limited partnership, % Total Fund (maximum 30%)	12.4%

3 Policy and Resource Implications

Financial: Investment of £75m 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:**

<i>Environmental:</i>	See section 2.9
<i>Social, including Article 19 opportunities:</i>	See section 2.9
<i>Economic:</i>	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 £75m in Legal & General UK Build to Rent Fund by the Direct Investment Portfolio.

Investment Manager: Legal & General (“L&G”)

The Legal & General Life Assurance Company was founded in London in 1836.

The Legal & General Group is now a FTSE 100 company, the UK’s largest provider of individual life assurance products, and a market leader in managing retirement risk for pension schemes. With around 9,000 employees, L&G looks after the financial security of over 10 million customers in the UK and US.

LGIM is the investment management arm of Legal & General Group. LGIM is Europe’s largest asset managers and a major global investor, with assets under management of £1.0tn (as at 31 December 2018).

The BtR Fund forms part of the L&G Real Assets (“L&G RA”) division, which was established in 2015 through the integration of the Group’s Infrastructure, Real Estate Lending and Property businesses within LGIM.

The RA division is a UK focused property investment manager with AUM of £31.4bn and significant experience in the residential sector. It has a dedicated team of expert personnel covering land origination, acquisitions, and planning, as well as the management of projects under construction and during the operational phase.

It participates in a growing range of housing activities which include urban regeneration (L&G manages the English Cities Fund with the Homes & Communities Agency through which it is developing 3,000 homes, as well as having invested £162m in a project in East Leeds which will result in 7,000 new homes and significant infrastructure improvements).

L&G RA is also involved in:

- financing affordable homes (£252m was invested with Places for People Group enabling 7,000 new homes to be built);
- the private housebuilding sector (L&G acquired Cala Homes in 2013);
- the creation of a modular housing manufacturing business in the North of England (L&G Homes);
- the development of student accommodation (over £1bn invested in 17,600 student accommodation units across a number of universities); and
- the development of care homes.

Investment Specific Risks

Property Development Risk

The BtR Fund will assume a one-third share of the development risk on individual development projects through co-investments in the Access Development Partnership (“Access”) alongside fellow stakeholders, L&G and PGGM. In this way the fund will mitigate the development risk by sharing it with two other significant investors, while allowing it to benefit from a share of any development gains.

L&G’s preference is to act as the developer using its own in-house development team for each project, to control the design and construction process. Where this is the case, it will accept controlled / limited planning risk only in respect of sites which either have outline permission for residential usage or where there is clear planning policy supporting residential development. It will however fund third party developers through the construction phase if this facilitates opportunities which would otherwise not be available however in this scenario, planning risk will be very limited.

The L&G RA team has extensive experience in the property development process from site identification, planning, acquisition, development and construction.

Construction Risk

Where Access is the developer it will engage strong / reputable national construction contractors on fixed price building contracts, which incorporate performance bonds and/or parent company guarantees as applicable, to ensure there is an appropriate level of financial comfort available in the event of the failure of the contractor.

The construction contracts will include provisions for payments to be made in arrears and subject to formal development valuations, with cost over-runs being for the contractor’s account with financial penalties for delays in completion.

The risk of contractors failing cannot be completely eliminated and in such a scenario L&G would require to replace the contractors using the performance bonds, guarantees, contract retentions and other measures to cover the extra financial costs.

Letting Risk

As all the Fund’s developments are of a significant scale (at least 150 units each with the largest to date being Woolwich with 659 units), a comprehensive initial marketing and letting strategy is required for each asset with a view to optimising the long term rental values, and specifically to avoid market distortions due to the volume of units becoming available at the same time.

Marketing and pre-letting registration campaigns will commence three months prior to completion leading to the first phase of lettings, with subsequent phases being designed, structured and carefully controlled once all amenities are complete and operational.

The benefit of a phased letting approach is to avoid excessive supply and downwards pressure on rental values, tenant arrival congestion and future expiry risk (i.e. too many leases potentially expiring at the same time).