Glasgow City Council

Strathclyde Pension Fund Committee

Item 5(c)

2nd June 2021

Report by Richard McIndoe, Director of Strathclyde Pension Fund

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Direct Investment Portfolio (DIP)
Investment Proposal – Funding Affordable Homes

Purpose of Report:

To set out a proposal for an investment of £30m within the Direct Investment Portfolio.

Recommendations:

The Committee is asked to **APPROVE** an investment of £30m in Funding Affordable Homes 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 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.
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 by the Sounding Board to the Committee.

2 New Investment Proposal

2.1 Key Terms

Name	Funding Affordable Homes
Investment vehicle	Closed-ended investment fund incorporated in Luxembourg & regulated by the CSSF
Manager	Edmond de Rothschild Real Estate Investment Management
Sector	Affordable and specialist UK housing
Investment objective	To increase the number of affordable & specialist homes, deliver positive social value & provide attractive and stable returns to investors
Term	Evergreen fund subject to an investors' continuation vote every 5 years from 2030
Target size	£300m
Proposed DIP investment	£30m
Target return	Internal Rate of Return (IRR) of 7%+ (Net) / Average Cash Yield of 4%+ p.a.

2.2 Investment Summary

Funding Affordable Homes (FAH) is a social impact investment company which was established in 2015 as one of the first private sector entities investing in government regulated affordable and supported housing accommodation and is part of Edmond de Rothschild (EdR) Real Estate Investment Management (REIM).

FAH is contributing to the increase in supply of high quality, affordable and specialised housing in the UK for individuals and families with identifiable social needs and is seeking to continue to grow its portfolio of assets, whilst generating attractive long-term, risk-adjusted investment returns to investors.

FAH invests in both General Needs and Specialist housing.

General Needs housing comprises social & affordable rental accommodation with regulated (i.e. discounted) rents. This is in addition to shared ownership homes which have lower rental yields but generate short term cashflow from the incremental sale of partial stakes in individual homes to the owner/tenant. This enables FAH to reinvest the proceeds into additional housing stock. A maximum of 7% of the Fund may be invested into private rented units.

Specialist housing includes affordable housing for older people with access to low level care support as required, and for individuals with learning, physical and/or mental health care needs and also those at risk of homelessness.

A commitment by the Direct Investment Portfolio of £30m to Funding Affordable Homes is proposed.

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

2.3 Investment Rationale

The UK has a long-term, structural shortfall in housing which is particularly acute in the affordable and supported sub-sectors of the market.

It is generally accepted that 300,000 homes require to be built annually, of which at least 100,000 are needed for the affordable housing sub-sector. Housing completions however have been running at around half this level for the last 30 years or so. A consequence of this is that c.1.2 million households are currently on local authority housing waiting lists across the UK.

FAH seeks to continue contributing towards addressing this shortfall of affordable/supported housing by developing (or acquiring) and then leasing developments to high credit quality housing partners (local authorities and/or housing associations/HAs) under long-term (20-30 years) index-linked leases. The housing partners will, in turn sublet the properties to qualifying tenants.

FAH will either develop or acquire assets on the following bases:-

- Forward Funding (i.e. the acquisition of the undeveloped sites with the construction by the developer/vendor being funded/monitored by FAH);
- Forward Commitment (the acquisition of the properties from the developer/vendor on completion with no funding provided);
- Acquisition of housing stock - this could be direct from housebuilders at bulk discounts (typically 15% to 25%), or of Section 106 housing units by FAH's own housing association (FAHHA);

No more than 10% of the Fund's capital may be invested into projects where the Fund is taking a full or partial development role.

Having its own HA (or Registered Provider/RP) enables FAH to acquire or develop regulated housing which either benefits from government grants, has been built on free or subsidised land provided by local authorities, or comprises Section 106 properties (Section 75 in Scotland). These require housebuilders, as part of their planning conditions, to build a number of affordable homes within each private residential development and sell them to a RP regulated by the Regulator of Social Housing.

FAH will employ a leveraged strategy with a maximum Loan to Value of 50%.

The fund:

- currently owns a diversified portfolio of 11 assets (8 Specialist / 3 General Needs housing) all of which are now operational. These include projects in Luton, Harwich, Northampton, Aldershot, Tower Hamlets (London) and the Isle of Wight amongst others, representing 871 housing units accommodating up to 1,431 people;
- has an advanced pipeline of 10 projects (8 General Needs / 2 Specialist housing, representing a total of 925 housing units) either in the initial stages of construction, exclusivity, or subject to detailed planning.

The fund's existing investors include high profile social impact investors such as Big Society Capital and The Joseph Rowntree Foundation while FAH's grant funders include Homes England and the Greater London Authority. EdR has committed £5m to date (maximum £6m subject to funding) and the alignment with investors is therefore considered satisfactory.

2.4 Risks

The main risks of the proposed investment in the CHF are considered to be:

- Development / Construction Risk
- Site Origination Risk
- Tenant / Management Risk

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

2.5 Projected Return

FAH is targeting an Internal Rate of Return (IRR) of 7%+ (Net) with a target, average cash yield of 4%+ p.a. over the period to 2030. The target return and yield are considered satisfactory given the perceived risk of the fund's investment strategy.

2.6 Exit

FAH has an initial term of 10 years to 2030 when the investors will have a continuation vote, and again thereafter on a 5-yearly basis. This requires a 75% majority to terminate the Fund, although below this threshold, FAH will use best endeavours to accommodate investors who wish to exit, via sales to existing or new investors and/or via asset sales.

2.7 Fees

The fee structure for the fund encompasses separate elements including a management fee, a fixed percentage transaction fee on acquisitions and a fixed management service fee (i.e. a reallocation of internal costs) in respect of FAHHA. The management fee is structured on a reducing scale linked to the total amount of commitments secured from investors, with the reductions commencing at a point materially below the target fund size.

The transaction fee is payable on each asset acquisition and/or disposal, although material disposals are not anticipated. It reflects the cost of the significant management resource involved at the time of acquiring individual developments and is intended to recompense the Manager at the point of maximum activity with multiple stakeholders. It does however allow for a lower annual management fee than would otherwise apply and also reflects the absence of a carried interest (i.e. performance) fee.

The fee structure is typical for a property fund and is considered acceptable.

2.8 Environmental Social and Governance Issues

FAH's strategy is to maximise the social impact of its investments and each investment requires to deliver tangible social benefits. Each project is assessed prior to investment to ensure that it is capable of delivering a measurable positive social outcome under a Social Performance Assessment Framework, independently evaluated by The Good Economy Partnership (a leading social advisory firm). This includes social need, additionality, affordability, potential to deliver social outcomes and quality of management. Projects not capable of achieving the required threshold will not proceed. FAH also commissions an annual report to examine the social performance and impact of the fund's investments. These have been undertaken to date by The Good Economy and have confirmed that FAH is meeting, or in many respects exceeding its social objectives.

EdR REIM is a signatory of the UN Principles of Responsible Investment.

2.9 Investment Size and Cash Requirements

SPF Fund value at 31st March 2021	£ 26,176m
DIP allocation (target 5% of main fund) NAV	£ 1,309m
Current DIP NAV	£ 920m
Headroom v NAV	**£ 389m**

2.10 Investment Strategy
The proposed investment falls within the Property sector and therefore the Fund's long term enhanced yield allocation (LTEY).

Allocations following this investment, based on Fund values at 31st March 2021 and total DIP commitments to Property, would be as follows:

Property, £ in DIP	£335m
Property, % in DIP	20%
Property in DIP, as % of Total Fund	1.3%
LTEY, % Total Fund (target 20%)	14.6%

3 Policy and Resource Implications

Financial: Investment of £30m to be drawn as required. Fee structure is 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: Strathclyde Pension Fund aligns with the theme of a well governed city.

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.	The proposal is anticipated to result in the development of additional affordable housing and specialist/supported living accommodation.
Sustainability Impacts:	
Environmental:	See section 2.8
Social, including opportunities under Article 20 of the European Public Procurement Directive:	See section 2.8
Economic:	See section 2.8
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 £30m in Funding Affordable Homes by the Direct Investment Portfolio.

Schedule 1

Investment Manager - Edmond de Rothschild REIM

FAH/EdR REIM are part of Edmond de Rothschild's European Property Investment Management Division which has 9 offices, 130 investment professionals and Assets under Management (AUM) of €10.4bn, mainly in the UK, France, Germany, Benelux and Switzerland.

The experience, credentials and business networks of the FAH board, non-executive directors as well as the support of the EdR team/platform means that FAH has a high level of credibility with HAs, local authorities and the housing regulatory bodies.

The senior members of FAH management team are Paul Munday, Adam Broadway, Greg Campbell and Linda Coopersmith.

Paul Munday (Fund Manager) – 25 years of affordable housing experience and has been directly involved in the development, acquisition and/or construction of over 10,000 affordable homes. Paul has executive responsibility for leading FAH.

Adam Broadway (Director of New Business) – also has 25 years' experience in affordable housing development and planning, including director level positions at 2 regional HAs. Responsible for sourcing and delivering General Needs housing opportunities.

Linda Coopersmith (Head of Legal Services) – former partner at Trowers and Hamlins, a leading firm of affordable housing lawyers with extensive experience of property, development and project financing.

The FAH executive team is supported by EdR's residential property team/platform, in addition to a highly experienced Fund Board comprising:-

Jaume Sabater (Chair) – Former director at EdR's private bank, specialising in property and alternative investments;

Debby Ounsted (Non-Exec Director) - former i) Chair of The Joseph Rowntree Foundation and ii) CEO of two HAs and currently a management consultant within the affordable housing sector;

Richard McCarthy (Non-Exec Director) - former i) Director General of the Dept for Communities & Local Government responsible for English housing & planning policy; ii) Chairman of the National Housing Federation; and ii) CEO of The Peabody Trust;

Keith Jenkins (Chairman, FAHHA) – Currently a consultant at Devonshires and former partner at Winckworth Sherwood (both firms of solicitors), with 30 years' experience with HAs and local authorities.

Greg Campbell (Adviser) – Partner and founder of Campbell Tickell, a leading advisory firm to the affordable housing sector. He has advised over 350 HAs including some of the largest in the UK and is currently an advisor to the housing regulators in England & Ireland as well as numerous local authorities.

Investment Specific Risks

Development / Construction Risk

The vast majority of developments will be structured on a forward funding or payment on completion model and a maximum of 10% of the fund may be deployed where the Manager is assuming a development role. Where this is the case the contractors will be engaged on fixed price building contracts, with the risk of cost-overruns borne by the contractor with penalties being payable by the contractors for any delays in delivery. The contracts will incorporate performance bonds and/or parent company guarantees as applicable, to ensure an appropriate level of financial surety is available in the event of contractor failure.

The Manager has extensive experience in the property development process from site identification, planning, acquisition, though to the managing and monitoring of the construction process. Planning consent will be in place prior to acquisition so planning risk won't be assumed.

Site Origination Risk

The fund's management team has recently completed the last of the current portfolio of 11 operational assets and subject to raising the required funding, is now in a position to progress with the advanced pipeline of opportunities, the top 10 of which represent a gross cost of c.£150m (equivalent to an equity requirement of c.£78m) for deployment over the next 24 months. This is in addition to a further, less advanced pipeline of over 40 projects (value £800m) at various stages of development.

The risk of FAH failing to identify sufficient development sites to deploy the fund is therefore considered low.

Tenant / Management Risk

The tenant occupancy/credit risk, as well as the repairs/maintenance obligation relating to the units leased to HAs/local authorities, will remain with the head tenant.

HAs and local authorities in particular are generally considered to be relatively strong credit quality counterparties, although formal assessment on an individual case by case basis will be undertaken by the Manager in respect of each development/lease.