Building social returns

Summary
• A housing shortage and increased demand has made real estate investment more attractive to pension schemes.
• There are several areas of real estate investment, each with their own nuances.
• The social and environmental benefits of well-organised investment can be huge, but they must be balanced with returns.
• There are risks to be aware of and pension investors should ensure they work with capable investment managers.

Investment in housing could suit pension schemes' long-term investment horizons and ESG considerations, but how does each housing sector differ and do the returns match their ESG credentials? Jack Gray investigates

The UK is currently experiencing a housing crisis. There is a shortage of homes, and increased mortgage rates and a reduction in social housing has led to a decline in home ownership and growth in the private rented sector (PRS). The government is aiming to build 300,000 new homes each year to keep up with demand, but less than 250,000 were built in 2023.

This could present an opportunity for pension schemes to invest in several areas of real estate. The long-term investment horizons and social benefits may be attractive, but there are questions as to whether the returns are equally attractive, and there are risks to consider.

Russell Investments director, private markets, Sam Steele, notes that real estate investment has evolved: "Traditionally, 10 or more years ago, it was mainly through the real estate investment trust sector, mainly on the listed side. We've seen more of this infiltration into the unlisted side.

"We are all very familiar with the residential sector, but as an institutional asset class it never used to feature within a private real estate portfolio. The three components used to mainly be retail, office and logistics."

The Covid-19 pandemic and online shopping have affected the retail side, Steele adds, while the residential side has seen growth amid increased demand.

"We're seeing the diversified real estate funds starting to add residential to their exposures," she continues. "We're also starting to see an influx of more availability on the sector-specific residential funds.

"What we see managers doing is trying to group the residential sector under a certain category – the 'living sector' – mainly in the PRS, senior care, and student housing."

However, Hymans Robertson senior investment research consultant, Steven Grahame, argues schemes need to be "realistic", as residential investment is relatively new and small in comparison to the commercial property investment.

"The commercial property market offers access to a greater range of strategies, managers, and risk profiles, boasting quantifiable track records with businesses and management teams that are both professional and financially stable," he says.

"We believe there is a role for institutional investment into residential sector and the primary focus of our clients' efforts have been building new homes and considering a mix of housing types across the country."

Differing areas of investment

When considering residential real estate, there are several areas in which pension monies can be invested, each with their own nuances.

"Pension funds can invest by buying existing housing assets or being an early-stage investor in the construction phase," explains Legal & General (L&G) head of residential, asset management, Dan Batterton. "L&G does this through a mixture of both using its own balance sheet and pooling our capital with other like-minded investors, which can produce benefits such as increased diversification and economies of scale."

Amid growth in the rental sector, PIC Capital head of long income, James Agar, notes that institutional investors are particularly attracted to the build-to-rent (BTR) sector due to its track record of long-term financial stability.

"BTR developments typically involve the construction of large-scale residential assets designed specifically to cater to the growing demand for high-quality rental housing," Agar states.

"These properties provide reliable income streams through the rents received, making them appealing to investors looking for long-term cashflows. The predictable nature of rental income, coupled with the growing trend of renting over homeownership, particularly among younger generations, ensures strong demand."

Abrdn head of operational real estate, James Dunne, believes that the biggest opportunities are in the BTR sector.

"In our view, it is the area where there is most need for institutional investment. Currently there are 4.5-5 million private rental homes in the UK and less than 3 per cent of those are owned by institutions. The rest is owned by individual buy-to-let landlords. However, this group has been selling off assets – creating greater opportunities for institutional money," he says.

"BTR is different from sectors such as student or senior living: With those sub-sectors, you already have a defined demographic you are targeting. Whereas with BTR, you could be appealing to much broader groups."

Another sector in demand is affordable housing, with Agar stating that investment in housing associations plays a crucial role in addressing the UK's affordable housing shortage.

"These investments not only enhance the availability of affordable housing, but the strong regulation of the sector also ensures that developments meet stringent standards, ultimately contributing to the wellbeing and stability of communities by protecting some of the most vulnerable individuals in our society."

"You can pick and choose the different sectors, but it comes down to the expertise of the underlying managers"

Dunne explains that affordable housing requires ownership through a registered provider who is responsible for the management of the assets, and a more indirect approach to investing may be more suitable when looking to access this market.

As the population in the UK ages, the senior living sector has also come into the spotlight. Agar says that this demographic shift presents a burgeoning field for investment in senior living, making it an increasingly attractive market for institutional investors.

"The increasing demand for retirement living creates favourable market conditions – with long-term planning horizons and consistent and predictable sources of revenue," he continues. "Nevertheless, there are barriers to investment in this sector, particularly the inadequate provision for older people's housing in local and national planning policies."

Looking towards the younger generations, Dunne notes that purpose-built student accommodation is the most commercialised of the residential sub-sectors and the one in which the greatest number of pension schemes are likely to be invested.

"This is because it's arguably the simplest sub-sector to understand – you are targeted at just one cohort of individuals with just one letting period per annum," he adds.

When investing in different real estate classes, Steele says that it comes down to the actual manager and their expertise in managing those products.

"They are very individual and require different skill sets," she states. "Student housing is very different to PRS in terms of the things you need to consider when you are doing the construction phase and then the whole management piece as well. The same with age care.

"You need to have the expertise and the knowledge because a lot of these sectors are highly regulated. Understanding the regulations and working with the local authorities is important. You can pick and choose the different sectors, but it comes down to the expertise of the underlying managers."

Dunne argues that the key to success when investing in the residential sector is paying close attention to the operation of the asset: "This is not a passive investment – it should be actively managed. But that is not the role of the pension company. It is the role of the investment manager. The closer the investment manager is to the operations, the better the outcomes will be for the pension company."

Meanwhile, L&G Affordable Homes CEO, Ben Denton, notes that social impact and long-term returns can be optimised through investing based on

the local demand for, and existing levels of investment in, each type of tenure.

"Similarly, pension funds should seek to identify the areas of greatest need when investing in affordable housing, to maximise its impact on communities," he continues.

"Regulation plays a role, with English regulation of affordable housing meaning that homes must be owned by a registered provider, who carefully manages their financial sustainability. This regulatory oversight aligns with the interests of investors: Protecting assets, managing reputational risk and ensuring a stable operating environment."

Market performance

When considering which real estate sectors to invest in, pension schemes will understandably be looking at returns. There are several factors to consider and, while there is huge demand for housing, Agar notes that the current landscape of property development in the UK is "increasingly challenging", primarily driven by the pressures of inflation and the lower yields relative to other asset classes, including gilts, since the LDI crisis.

"The bout of high inflation meant the cost of construction and materials escalated significantly, impacting the viability of new housing projects," he says. "Furthermore, the material repricing of gilts, which has been generally beneficial for the funding position of UK DB pension schemes, has had profound implications for financing development."

Despite this, Steele says that returns are attractive from a rental growth perspective: "We're seeing good rental growth come through at around the region of 8-9 per cent. When you look at the return profile, the overall capital growth potentially is not as high, we are seeing 5-7 per cent as returns that you can get from these investments, obviously with a significant exposure to income.

"I think the thing that's concerning is the interest rate situation, inflation and that a lot of households are feeling the squeeze. We are seeing yields range in the region of 4-5 per cent depending on where you are."

L&G head of housing investments, institutional retirement, Hayley Holness, highlights that residential rents typically offer attractive inflation-linked or correlated cashflows.

"From an investor perspective, given increases in risk-free rates, the relative value has been more challenging, which has led to yields on property increasing," she explains. "This higher yield can now provide an attractive entry point for new investors, who are likely to achieve healthy yearly returns over the medium term."

Steele notes that repurposing an asset, say from an office to residential, can be more beneficial as it is brownfield, but that also comes at a significant cost in terms of repositioning and existing assets may not be up to scratch from an ESG standpoint.

Grahame adds: "We are finding that investment opportunity is evolving. There were some early market participants in which there have been some lessons learnt.

"The linkage to income and earnings is additional feature within a portfolio for an allocation to residential property. However, the key standout feature is that the shortage of supply meaning that occupancy levels are high and there is very little void risk.

"The cost is a negative impact on the returns and to date this has tended to favour large single purpose-built buildings offering flats rather than single houses. Overall, we are encouraged by how the industry is evolving and look forward to greater professionalism that drive larger investment flows."

Social and environmental benefits

Pension investment in real estate can have benefits both environmentally and socially. On the social side, the benefits of creating affordable housing is obvious: It gives people with squeezed household incomes a viable place to live. However, there are other social benefits, such as regeneration projects.

"PIC is a major investor in UK housing and regeneration projects," says Agar. "Our experience shows that they create significant social value and as well as drive economic growth across the UK.

"Regeneration will most likely be a key component of the incoming government's plan to reinvigorate regional economic growth and raise Britain's productivity levels. Such large-scale projects also create significant social value for local areas, including skilled jobs, apprenticeships, improved healthcare outcomes, and economic inflows into local businesses."

Dunne adds that the social side is particularly relevant to residential, and managers with an operational arm can have a direct positive impact.

"For us at Abrdn that takes a variety of forms, but a key part is making sure that we create communities in our buildings while also making them part of the wider community," he states.

"It's a virtuous circle: We've found that the more people feel part of a community in a building, the longer they will stay. The longer they stay, the better for the end investor."

There is also a strong social dimension to the development of quality housing, especially against the backdrop of a "major housing shortage", says Denton.

"BTR and suburban BTR enable those seeking to rent to avoid the notoriously challenging private rented sector, offering an opportunity to live in well-managed homes with fair rent policies and longer-term certainty.

"Student housing provides students with safe and well-designed housing that can help them excel in their studies, while affordable housing has a particular social focus in that it caters to those in the greatest need."

Steele notes that, on the environmental side, the residential sector accounts for 29 per cent of carbon emissions.

"There is a lot of scope to make improvements, particularly if you are driving a very strong ESG focus or an impact strategy, you can have a significant impact with some of these investments," she says. "You can build in green leases with your tenants so you can start recording and collecting data, there is opportunity to have more control with the residential sector than different tenant groups."

The development of new energy-efficient housing and the retrofitting of older stock to improve its energy efficiency can play a huge role in meeting the country's environmental targets, Denton adds.

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Assessing the risks

As with any asset class, real estate investments come with risks. There have been several scandals involving properties in which pension monies is invested, leading to court cases and reputational damage. When investing in real estate, Grahame notes that cladding is a "significant issue" for the industry.

"We tend to favour new buildings and seek assurance from those managers that have existing portfolios," he says. "It remains an area of some frustration that disclosure hasn't been as willing or as good as we would have liked."

Dunne emphasises that, in residential real estate, pension investors have to be rigorous on the safety of the building and ensure that everything is managed correctly.

"There are no compromises," he states. "The experience of your investment manager is crucial – pension funds should make sure they have a well-established, professional partner that understands the risks and regulation, particularly as the regulatory landscape in this area is constantly evolving."

Regulatory changes include the recently passed Leasehold and Freehold Reform Act, which is aimed at eradicating bad practice in areas such as ground rents and property management, whilst making it easier and more viable for tenants to obtain an interest in their home for the long term.

"This could have some impact on ground rent investments into residential, but this is not an area that we believe is particularly suited to pension fund investors," says Dunne.

"Other legislation such as the Renters Reform Bill is aimed at eradicating rogue landlords and ensuring tenants have the capability and right to live in a property that is properly managed.

"As professional managers of this kind of accommodation, this is fundamental to our approach and the legislation is putting into law what we already do."

Also commenting on the Leasehold and Freehold Reform Act, Holness believes that the reforms will not affect L&G's ability to invest in housing.

"While we would factor the changes into our baseline assumptions regarding both new and existing shared ownership assets, they don't impact our ability to invest," she concludes.

Written by Jack Gray