APEX

Oxfordshire County Council Pension Fund

Social/Affordable Housing

Q4 2024

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Introduction to Impact investing

As a rule, impact investors look for a double dividend of financial returns alongside social and environmental benefits. The desired impact that an investor wishes to achieve can vary but is usually set out in terms of the United Nations 17 Sustainable Development Goals (SDGs) either as broad aims or targeting specific SDGs.

These are guidelines designed to provide a solid foundation for impact investors. Further sources of information can be found via the Global Impact Investing Network (GIIN) https://thegiin.org/impact-investing/ ; the Operating Principles for Impact Management https://www.impactprinciples.org/ and International Finance Corporation (IFC) – the World Bank's investment arm https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/development+impact/principles – each have established the following, largely overlapping principles.

1. Intentionality of the impact investment: The investment process starts off by defining the impact objective(s) at the core of the intended positive social and environmental affect aligned with some of the 17 UN SDGs or other widely accepted goals.

2. Aiming at financial returns: Apart from achieving the desired effect, impact investors aim for a financial return on capital that ranges from at least a market rate to a risk-adjusted market rate. This is to distinguish impact investment from philanthropy, which solely focuses on social or environmental change and not on financial returns.

3. Investments across asset classes: There are numerous opportunities across multiple types of asset classes, from private equity and private debt, to listed equities and "green bonds".

4. Managing and measuring impact: Defining indicators according to the intentions, then measure each investment's achievement and report results.

There is also much useful content on the investment issues in social and affordable housing provided by the Good Economy - https://thegoodeconomy.co.uk/resources/reports/Affordable-Housing-Equity-Investment-Models-Insight-Brief.pdf

Impact investing for LGPS Funds

Impact investing must be subordinate to the Committee's primary responsibility to ensure the Fund can pay current and future pensions. At its most positive, the impact made can produce a circular effect, improving outcomes and potentially investment returns. At its most damaging, it can be used as an excuse to target a pet project irrespective of expected returns. Because of this the four principles set out on the previous page are important. Whilst an existing committee may understand the issues around impact investing, I would strongly recommend that they produce an audit trail against the four principles to ensure that they can show their own duty of care and set a high bar for future committees.

A broader view on the preferences of Fund members and wider stakeholders can also be considered as well as potential Government direction towards UK based investment and , if relevant, wider disclosure within the Fund's Taskforce for Climate Related Financial disclosure (TCFD) report.

I would recommend that the financial return targeted should be equitable with other investment opportunities available in the market on a risk adjusted basis. At present the targeted return for the Strategic Benchmark, as recalculated in March 2022 using Hymans updated actuarial forecasts, is 4.0% per annum. Hymans give the probability of the Fund's assets (as at March 2022) achieving this return into the future as 77%. This comprises with assets targeting higher return forecasts for higher risk investments e.g. Private Equity (forecast return of 9.1% p.a. with an annualised volatility of 17.2%) and lower return/lower risk investments e.g. UK Government Gilts (forecast return of 4% p.a. with an annualised volatility of 7.7%). Hymans will review the target return for the Fund at the time of the actuarial revaluation in March 2025. The outcome of this is likely to see a higher targeted return set for the Fund.

The level of return targeted for an impact investment should be commensurate with that investment's particular risk and return profile as well as recognising any diversification benefits it may bring to the Fund. The Committee could justify an impact investment by targeting a return of at least 5-6% per annum and preferably higher whilst targeting the investment in such a way as to maximise the diversification benefits away from the predominant equity risk within the existing portfolio. Ideally, the actuary's targeted return for the Fund can be used as a base level for desired return for an impact portfolio as it can then be argued that such a portfolio is not a drag on the Fund's required return.

Social/Affordable Housing

One area which has attracted interest from the LGPS sector is the provision of social housing, partly because this is a local government responsibility. This fits with a number of the UN SDGs, particularly No.11 - Sustainable Cities and Communities. But, in addition, having a decent, affordable home is an important determinant of people's health and well-being (Goal 3); has a positive effect on children's education (Goal 4); can help people get and sustain employment (Goal 8) and can provide a route out of poverty (Goal 1). Housing's carbon footprint can also be reduced through the right energy efficiency and construction measures (Goals 7 and 13).

Social Housing covers a number of sub-sectors, each of which have their own specific structure around payment of rent to the landlord and payment of care costs where necessary. The greater the percentage of the rent covered by the Government through the MHCLG or DWP budget, the lower the perceived investment risk.

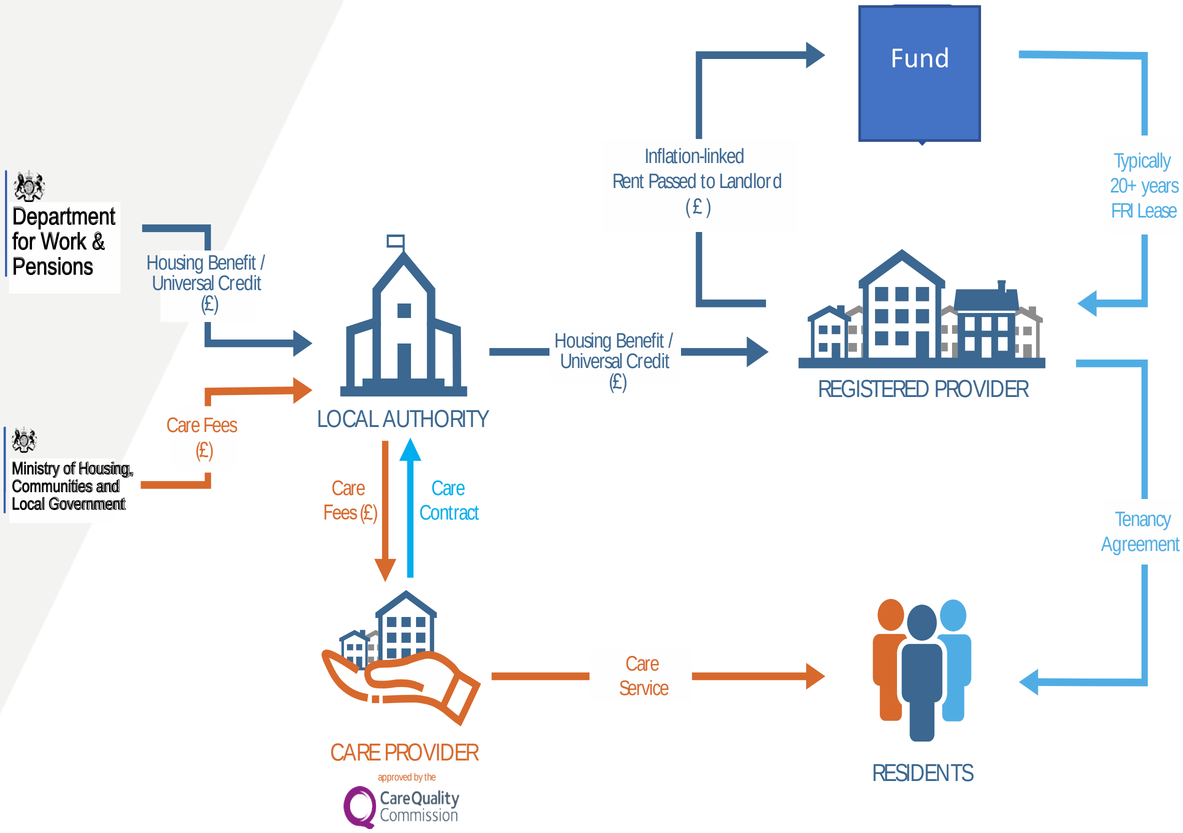
The table below is taken from a presentation by the Triple Point Impact House Fund.

Sector	Children's Services Housing	Specialised Supported Housing	Older Person Supported Housing	Social and Affordable Housing	Homelessness Housing	Private Affordable Housing	Asylum Housing
Residents	People under 18 years with care and support needs	Individuals of working age with care and support needs	Individuals and couples over 55 with care and support needs	Families and individuals	Families and individuals registered as homeless	Families and individuals	Families and individuals seeking asylum
Lessee	Care Provider	Registered Provider	Registered Provider	Local Authority / Registered Provider	Local Authority / Registered Provider / Charity	Individuals and Families	Private Provider
Income Source	Ministry of Housing Communities and Local Government	Department for Work & Pensions	Department for Work & Pensions	Department for Work & Pensions with private top up	Department for Work & Pensions	Private payments with contributions from the Department for Work and Pensions	Home Office
Lease Length	10 years +	10 years +	10 years +	10 years +	10 years +	Assured Shorthold Tenancy	10 years
Target Net Initial Yield	5.5 – 6.5%	5.5 – 6.0%	4.5 – 5.5%	4.0 – 6.0%	4.5 – 7.0%	5.0 – 7.0%	6.0 – 9.0%

The UK currently builds around 175,000 affordable houses a year but the need is estimated at 300,000 per annum which could cost an additional £30bn per annum. Typically, social housing refers to housing provided by the state (publicly owned) whereas affordable housing refers to housing provided privately often within government regulation and support towards lower rents.

The most advantageous position to be in as an asset owner in Social Housing is to have all rent paid directly by the local authority rather than via the tenant from housing benefit (see income source in the table above) and for the asset owner/landlord to have a contract with the lessee where the service or care provider covers all voids and maintenance. This reduces the investment risk but still leaves the asset owner at risk to a change in Government policy, although the need for social care provision is highly unlikely to go away. However, the more the risks are absorbed by the service provider the lower the likely return.

The flow chart below illustrates the older person supported housing sector



Investment would usually be via a fund which owns the properties being used to provide Social/Affordable Housing. As can be seen from the table on the previous page, properties are usually owned and leased to service providers on long leases although many funds are now looking to build new social housing in order to guarantee a better build quality and achieve environmental commitments such as low carbon emissions. Investors are often locked in for the early stages of the fund and liquidity may be quarterly or annually thereafter. Some funds allow gearing to boost investors' returns but this obviously increases the risk. Although the investor only owns the underlying properties, reputational risk is likely to include the actions of the care provider.

Owning property directly does expose the investor to movement in house prices and a potential fall in value. I would advise looking to minimise this exposure where possible and concentrate on stable income rather than higher return.

There are a number of fund managers operating in the social housing sector in the UK, including ones large enough for the Fund to invest up to 5% of its assets. The investment would be drawn down over a number of years as the underlying fund invests its capital with rental income paid quarterly. If the fund is close-ended, capital would be returned at the end of the fund's life, often 10 years or so but, increasingly, the sector is moving to evergreen funds which are long-term funds with periodic liquidity windows where any investment should be seen as a 20-year plus commitment. Rents should be either implicitly or explicitly linked to inflation and, as such, Social Housing can provide a useful source of protection against a long-term uptick in inflation.

Investing in Social/Affordable Housing does carry risks, particularly reputational and operators can be fined by the Housing Ombudsman (as happened to Peabody Trust in 2023 although the reputational damage and costs associated with repairing this almost certainly outweigh the financial impact of the fine). It is therefore important to look through the asset manager to the housing partners they are working with. A good defence against poor behavioural practises of the operator is to set out clearly the intended social impact of the investment and then monitor this impact. Are the tenants of the housing provided improving their quality of life? How can this be measured? Any unfair practices should show up in this style of metric before they get exposed in the press. In this sector more than others, asset managers should be held to a high standard of transparency and integrity. This sector cannot be looked at purely as a financial investment without encouraging poor behaviour which targets financial return over the provision of social good.

One of the supposed advantages of investing in Social Housing for LGPS funds is the ability to support the aims of its administrating authority, this can be done by requiring any fund the Pension Fund invests in to target Social Housing within the county of Oxfordshire. Many fund managers will acquiesce to this and there are various ways of structuring this which will need to be considered in detail. The more explicit the local investment the higher the cost of the structure used, the more implicit the lower the cost but the lower the certainty that the local investment will be achieved.

This raises a very obvious conflict of interest for the Councillors: If the intention is to achieve a social good alongside a financial return, why target your own borough over all others irrespective of its relative investment merits? From an investment prospective, I do believe a pension fund can target impact investing for a proportion of its assets. I am less sure of the justification for insisting that the impact investment must be in the locality of the administrating borough. This sounds more like politics! If the intention is to invest locally, a strong audit trail needs to be created for the decision and a strong governance over the role of elected Councillors, including those on the Pensions Committee, set out before investment.

A less impactful way of investing into the provision of housing is via shared ownership housing which reduces the need for a large deposit allowing tenants to purchase the house in lumps over time whilst renting the unowned proportion of the property via a subsidised rent with affordability criteria or by just targeting the affordable rental sector. Both these approaches provide lower rents to tenants through receiving a grant from Homes England and passing this on to the tenant in some form. As there is much less provision of social care in these approaches, they can be seen as less impactful but carry less reputational risk and, as larger markets, would enable the Fund to invest at a faster pace. Returns here are forecast to be around the 7-8% per annum but do depend on an element of long-term house price appreciation.

Diversification

For much of the last 30 years asset owners have found diversification through holding both equities and bonds as they have tended to be negatively correlated (one rises when the other falls and vice versa). In a higher inflationary environment and particularly when inflation itself is more volatile, equities and bonds can be positively correlated and rise and fall at the same time. This means that the Fund becomes much less diversified and more prone to large swings in value. Social/Affordable Housing could provide a useful element of diversification. Most forms of Social/Affordable Housing are in short supply compared to demand, this will only increase in an economic recession as unemployment increases which is when equities and bonds may be falling in unison. In addition, rent received may be linked implicitly to inflation as it is often set at a discount to private sector rents and repriced periodically. Private rents tend to rise in line with inflation over the long term. Again, this is a useful attribute for a pension fund which has future liabilities which are inflation linked (future pension payments).

Risk and Return assumptions used in Apex Group modelling

Social/Affordable Housing is a relatively new asset class for institutional investors and, as such, we do not have enough historic data to create risk and return forecasts. Apex has, therefore, created risk and return assumptions based on their understanding of the investment properties of this asset class. The long-term return assumption (5.5% p.a.) has been taken from the average targeted return of managers operating in this asset class less a discount, and the volatility assumption has been calculated by assuming the same Sharpe Ratio as forecast for UK Real Estate. The actual return forecast will depend on the type of investment the Fund makes.

SHARPE RATIO: Risk-adjusted returns, where the portfolio returns over the risk-free rate are risk-adjusted.

$$Sharpe\ Ratio = \frac{Portfolio\ Return\ - Risk\ Free\ Rate}{Volatility\ of\ Portfolio}$$

This volatility assumption is highly likely to be an over-estimation as it does not take into account the specific dynamics of this sub asset class, especially its defensiveness in periods of economic turmoil.

Proposed structure of investment

Social/Affordable Housing has seen a rapid growth in interest from institutional investors over the last 5 years. This growth is almost self-fulfilling as greater interest leads to larger funds being raised leading to the requirement to deploy this cash which builds out the understanding of the sub asset class by house builders, Housing Associations and social care providers, thereby providing greater supply of available assets leading to the ability to commit larger funds. Whilst the early investment managers in this area have a 20 year track record, their initial funds were sub £100m. Funds are now being raised targeting £1bn plus, enabling investors to commit £50-£100m to one manager.

As noted previously, earlier funds in this area tended to be close-ended meaning that they committed to return capital to investors by a set date rather than being open in perpetuity. More recent fund launches are often evergreen with an unlimited life, recognising that the demand for Social/Affordable Housing is not going to go away. Given Oxfordshire’s size of approximately £3bn and the desire to potentially invest up to £50m into this area, selecting 1 or 2 managers would seem sensible. Given the variety of sub-sectors within this asset class, if using more than one manager, it would seem sensible to target managers investing into different areas of the Social/Affordable Housing sector to diversify risk and avoid competition for the same assets.

Also noted earlier was the need to keep any investment in line with the Fund’s fiduciary responsibility when investing locally. One of the most obvious ways to demonstrate this is to invest via a national fund which covers England and Wales or the whole of the UK and agree with the manager either to target the home region within that fund or to invest alongside that national fund with a local investment managed to the same risk and return parameters as the national fund, thereby showing no loss of return from the local investment. However, the local investment will be concentrated into a smaller number of developments so will likely come with a higher degree of specific risk.

The role of Brunel

Up until now Brunel have indicated that they do not feel they have the resources or knowledge to assist in the selection of investment managers in the Social/Affordable Housing space. Because of this, individual funds have acted independently and selected and appointed their own managers, often with the help of a consultant. I believe this has been a missed opportunity as acting more centrally could have lowered manager fees and lead to a better option for investing in the Brunel region rather than each member Fund looking to invest in its own County with the ensuing concentration risk. As a result there are now 5 Brunel member Funds investing through 5 separate investment managers but with some overlap as a number of member Funds are invested with more than one manager.

Brunel are now indicating that they would like to be involved in this area and are happy to help with manager selection and ongoing monitoring. However, I am not sure what extra resource Brunel have now employed or what level of understanding they have in this specific sector given the high reputational risk element.

In addition, much work has already been done by other member Funds. It should be possible to piggyback on much of this, particularly in terms of consultancy fees and manager fees. If the Committee is prepared to accept some of the work previously done elsewhere, the manager selection element of this proposal could be short circuited with the Fund accepting a short list recently produced for another member Fund. Due diligence and legal diligence on any manager could also be bought from those providers who have already done this work if the final manager selection is a manager who is already acting for another member Fund. I am aware that, with the appointments recently made by Gloucestershire in this space, they did negotiate a fee discount if further allocations were made to a manager by other Brunel member Funds. In addition, Brunel would wish to charge a fee on assets if the mandate is held within Brunel.

This does not reduce the costs or resources needed by your own officers in the ongoing monitoring of investment managers given that they would be appointed outside of Brunel.

Example of managers

The section below gives an outline of a number of the manager’s activities in this space as a way of showcasing the type of investments which are available. These are not recommendations.

PGIM Real Estate UK Affordable Housing Fund - Cornwall Investment of £65m, 90% targeting local investment via co-investment.

Size	£275m (82% invested); £140 as co-investment
Target sector	Affordable rent
Affordability	Rent <33% of tenant income
Return target yield	3.75%-5% per annum
Total targeted return	6%-9% per annum

The fund aims to acquire new build, single family housing of 40-250+ units per site. Homes to be let at affordable rents specifically with rent accounting for no more than 33% of tenant income and at a minimum of a 5% discount to open market rents. This is classed as affordable housing as there is no government or local government intervention or regulation. It will therefore have limited social impact outside of encouraging housebuilding in a given area and providing rents marginally below market levels. Returns are likely to be heavily impacted by returns in the private residential market. The properties are managed by the asset manager's own property manager.

This fund forms the core of the approach taken by Cornwall LGPS Fund. They have invested into the main, national fund and agreed a side commitment to be invested purely into the county of Cornwall. This latter investment may take the form of modular housing which reduces the cost of the build. This PGIM fund has the advantage of being a manager which Brunel has already selected within their UK property portfolio and for which they have therefore conducted due diligence. This allows the LGPS Fund to invest without repeating this work or conducting a manager selection exercise as Brunel have already selected this fund as 'best in breed'.

The fund currently is invested in the North West, West Midlands and East/East Midlands so an allocation from Oxfordshire could encourage the fund to extend its geographical exposure to the Oxfordshire area.

Because the housing is new build the Fund can set high environmental build standards.

M&G Shared Ownership Fund

The fund uses a shared ownership approach working with housing associations to lower the cost of entry into the housing market. The occupier purchases an initial 25% of the property with the fund retaining the remaining 75%. The occupier can get a mortgage on their 25% and the initial deposit at 10% of their financial commitment is also much lower. The occupier pays rental on the 75% not owned to the fund but this is at a below market rate and rises automatically with inflation. Rents are typically 20% below market rates. The fund is regulated and can therefore apply for grants from Homes England and the Greater London Authority which are interest free allowing them to offer below market rents.

Because the occupier has made a financial commitment in purchasing 25% of the house, the rate of delinquencies and repossessions is very low. Leases agreed with the service provider (Housing Association etc) are set at 999 years. If the occupier wishes to sell this can be done to a third party or repurchased by the fund with the price set by independent valuers. The fund covers the first 10 years of external maintenance on new builds.

The housing associations are happy to sell houses to the fund at a discount of around 20% to market values because their remit is to build new housing and increase the provision of affordable homes therefore they are interested in recycling their capital. This helps compensate the investor for the lower rental yield.

The occupier has the option to increase their stake in the house at annual intervals with the price set by independent valuers against the open market. Because the fund has bought the house from the housing association at a 20% discount, any sale of a part of the house to the occupier at full market price brings a capital gain, further increasing the returns to the fund.

The fund has purchased a large number of housing units in the south west (current focus in London and south east) from a Housing Association. This has allowed the fund to drawdown around £280m of committed capital

The fund is currently very active in seeking new investors as it currently has more potential sites than it can finance.

Size	£300m (80% invested)
Target sector	Shared ownership + affordable
Affordability	Rent < 80% market rates
Return target yield	3% per annum
Total targeted return	5%-7% per annum

Gresham House Affordable Housing Fund –Wiltshire investment of £50m; Gloucestershire investment of £85m (60% local investment); Devon £40m (50% local investment).

The shared ownership fund is similar in construct to the M&G Fund above but the manager has a longer track record in the sector of over 20 years. They target the delivery of affordable homes to key workers and focus on community regeneration projects.

Size	£311m raised to date, target is to raise ~£100m p.a.
Target sector	Shared ownership
Affordability	Rent < 80% market rates
Return target yield	3% per annum
Total targeted return	6% per annum

The fund is evergreen rather than closed end allowing for a longer term investment but any sale would require a buyer to be found, because of this there is a 5-year lock in and thereafter a 12-month notice period for sales.

Wiltshire used Mercers to conduct a manager search for Social/Affordable Housing funds. They rejected the PGIM fund despite the link to Brunel because it was too exposed to market rents and therefore added little in terms of impact or social benefit and chose the Gresham House fund over M&G due to their greater experience in this sector and longer track record. Gloucestershire used Reddington as consultant when selecting investment managers for a Social/Affordable Housing mandate and again selected Gresham House over the M&G fund.

Resonance Housing Fund – Targeting homelessness.

The fund manager has been active in this sector for over 20 years and is currently raising their second institutional fund focusing on homelessness which closes for new investment on the 31st December 2024. They will launch Fund 3 in the late spring and this will be an evergreen fund structure. They have raised £129m for fund 2 with the expectation that the fund grows toward £150-200m by the close.

Size	£120m initially , target £220m
Target sector	Homelessness
Affordability	Rent < 80% market rates
Return target yield	3% per annum
Total targeted return	6% per annum

It is estimated that there are 80,000 households currently living in inappropriate housing across the UK giving a market demand of over £20bn with the Government currently spending over £1bn per annum in excess housing costs alone. Because of the requirement for local councils to house homeless individuals, rents are supported.

Properties are acquired as single units or existing portfolios (including the windup of the previous fund which was London based). They have a strong relationship with service providers in the homelessness sector and provide detailed metrics on how the fund improves the outcomes for those residents in houses thereby showing the delivery of measurable social impact. Returns are underpinned by long-term contracts with charity partners who cover all material tenant risks including maintenance, voids etc with rents inflation linked. They are dependent on working with local councils which can affect their ability to invest in particular locations.

Octopus Affordable Housing Fund

Working across multiple sub-sectors of the Social/Affordable Housing market including shared /ownership; Rent to Buy; key worker and older person sectors. Investing via a mixture of forward funding new developments and acquiring existing assets from Housing Associations.

Size	£170m initially, long-term target £1,000m
Target sector	<35% older person. Includes shared ownership, key worker.
Affordability	>50% social and affordable rent
Return target yield	3.5% per annum
Total targeted return	7% per annum

This manager has the advantage of operating over various sub-sectors of the Social/Affordable Housing space which spreads the regulatory risk but does require the manager to be cognisant of all regulatory, social care and housing market issues affecting each aspect of their provision.

Conclusion

This paper is for discussion. To take this issue further the Committee could agree the following principles:

- To invest in Social/Affordable Housing given the diversification benefits to the Fund and ability to showcase social good.
- To agree a target rate of return marginally above that set by the actuary (4.0% based on 2022 figures but currently being reviewed as part of the triennial actuarial revaluation).
- Agree the balance between impact and return. This will help define the sub-sectors of the Social/Affordable Housing market that are targeted.
- Agree the balance between investing nationally and locally.
- Agree to look to invest up to £50m of the Fund via up to 2 managers across different sub-sectors of the Social/Affordable Housing landscape.

- To request a paper at the next Committee meeting setting out how this could be achieved and how this would work within the relationship with Brunel.