Whitepaper: UK Private Rented Residential Sector

An income generative infrastructure investment?

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For the Local Government Pension Scheme (LGPS), the Government's recent regulatory changes and the Brexit vote have fuelled economic uncertainty and created fresh challenges and opportunities.

Within the new Investment Regulations (and Guidance), the Government seeks to promote investment strategy diversification and has suggested that LGPS Funds can play a leading role in the development of the UK infrastructure – which has come under heavy pressure in the last decade as the UK's population has grown. Alongside this, Government also requires LGPS Funds to formulate a policy on Environmental, Social and Governance (ESG) considerations.

Given these requirements this paper considers the Cross Pool Collaboration Groups definition of infrastructure and talks to the potential case for UK Private Rented Sector ("PRS") residential investment being classified as a readily accessible infrastructure investment for the LGPS.

This paper covers:

- An overview of the LGPS Investment Regulations 2016
- What constitutes infrastructure, and why it is increasingly important to the LGPS?
- UK Private Residential Sector: Can this type of infrastructure investment benefit LGPS Funds?
- Conclusions
- Overview: Invesco Real Estate – UK Residential Fund

Overview: The LGPS Investment Regulations 2016

Funding pressures on both local authorities and other employers in the LGPS are resulting in the LGPS membership becoming increasingly mature with the proportions of inactive (deferred and pensioner) members progressively increasing compared to active members. This trend is set to continue with further ongoing public sector funding constraint and additional contracting out of services by both local authority and other LGPS employers.

Already by the financial year 2015-16 a significant proportion of Funds were cashflow negative in terms of contributions less benefits and expenses. Across the LGPS in England and Wales we believe that increasing numbers of Funds will become dependent on investment income to meet their expenses going forward.

Recognising these challenges, the 2016 LGPS Investment Regulations require all LGPS Funds in England and Wales to review their investment strategy and publish a new Investment Strategy Statement by 1 April 2017.

Within the regulations, LGPS Funds must ensure adequate investment strategy diversification across asset classes to reduce overall portfolio risk and formulate a policy for ESG. Greater LGPS participation in the development of UK infrastructure has also been proposed in recent Government statements. In contrast to the 2009 LGPS Investment Regulations, the 2016 Regulations (and Guidance) place a positive emphasis on ESG issues and require each Administering Authority to formulate a policy in this respect.

What constitutes infrastructure, and why it's increasingly important to the LGPS?

The Government required prospective LGPS Investment Pools to utilise the Cross Pool Collaboration Group Infrastructure Sub-Group definition of infrastructure when preparing their July 2016 Pooling proposals. This definition of infrastructure includes the following statement[1]:

Infrastructure assets are the facilities and structures needed for the functioning of communities and to support economic development. When considered as an investment asset class, infrastructure investments are normally expected to have most of the following characteristics:

- Substantially backed by durable physical assets
- Long life and low risk of obsolescence
- Identifiable and reliable cash flow, preferably either explicitly or implicitly inflation-linked
- Revenues largely isolated from the business cycle and competition, for example through long term contracts, regulated monopolies or high barriers to entry
- Returns to show limited correlation to other asset classes.

LGPS Investment Pooling has focused attention on infrastructure investing with "An improved capacity to invest in infrastructure" being one of the four criteria against which the Government assessed the submissions by prospective LGPS Investment Pools. In their July 2016 submissions, the majority of Pools stated a long-term ambition for a 10% allocation to infrastructure compared with a current average target of 3-4% amongst their individual Funds.

Given that the Pools stated their long-term ambition of 10% after consultation with their constituent Funds, it is likely that the new Investment Strategy Statements will see many LGPS Funds significantly increase their strategic allocations to infrastructure compared to the allocation in their existing Statement of Investment Principles. The results of the 2016 Actuarial Valuations and a desire to further diversify investment allocations to mitigate risk may also result in individual LGPS Funds, on average, increasing their strategic allocation to infrastructure.

However, access to appropriate infrastructure products is not straightforward for many LGPS Funds. Given the work required by even the most advanced of the Investment Pools over a wide range of regulatory and investment issues between now and 2018, including being able to offer Funds listed equity and credit products, we believe that few will be able to offer infrastructure as an asset class until sometime after April 2018. In our view, this is where certain established real estate funds could make an important contribution; by potentially offering LGPS Funds access to high quality UK based Infrastructure assets.

1 Source: Treasury and Department for Communities and Local Government 2016.

UK Private Rental Sector (PRS): Can this be considered an infrastructure investment for LGPS Funds?

We believe that UK PRS investment could meet the criteria of an infrastructure investment according to the Cross Pool Collaboration Group definition, and could provide several benefits to LGPS Funds looking to strengthen and diversify their portfolios to meet future liabilities. Below, we summarise the key characteristics of PRS that we believe are likely to be of interest to LGPS Funds:

1. Substantially backed by durable physical assets

Institutional grade PRS assets will be likely to pass the durability test if they are purpose designed and built rental properties (known as "Build to Rent or "BtR"); these are focused on providing both the level of accommodation and associated facilities that will be expected to attract a pool of tenants who may want to rent both over the short and long term. Based on this core strategy these Funds will be unlikely to purchase individual units or "broken blocks" from house builders or existing investors and instead they will be likely to choose to invest only in whole blocks of flats which have been specifically designed for the purpose of "Build to Rent."

The image below shows an example of a 180 unit BtR scheme (the tower highlighted) that forms part of a larger development project that has been funded by the Invesco Real Estate – UK Residential Fund.

In addition, it is expected that these purpose designed BtR buildings will have dedicated on-site management staff who will oversee any amenity facilities and the communal areas and help to ensure the ongoing quality of individual flats for the tenants is maintained over the long term. This will be a point of differentiation from many other rental properties currently available in the UK PRS sector.

Strong ESG characteristics are a feature of genuinely durable physical assets. ESG and sustainability are becoming key drivers during acquisition planning, development and ongoing property management of the BtR assets. To illustrate this, Invesco Real Estate has incorporated ESG practices into its real estate investment strategy since 2008, and continues to push the boundaries of its program to encompass energy efficiency, water, waste and recycling, renewable energy, tenant and community engagement, and most recently health and well-being.

180 unit Build to Rent development – Sutton, London

In addition, based on current planning requirements a new build residential scheme in the UK will initially be required to start with an energy statement / strategy, which is then demonstrated through the PEA (Predictive Energy Assessment) at design stage, which is then confirmed at the end of construction with the EPC (Energy Performance Certificate).

It is also worth mentioning that since October 2016, in Greater London, developers have to deliver to "zero carbon" (over and above the 2013 Building Regulations) residential developments, which currently sees the design of the building typically achieving a 40-50% reduction, with the remaining 50-60% being achieved via a financial contribution to the Local Authority.

As from the 1st April 2018 there will be a requirement for any properties rented out in the PRS to normally have a minimum energy performance rating of "E" on an EPC. The regulations will come into force for new lets and renewals of tenancies with effect from 1st April 2018 and for all existing tenancies on 1st April 2020. It will be unlawful to rent a property which breaches the requirement for a minimum E rating, unless there is an applicable exemption.

The assets of a UK PRS fund should also support both the functioning of communities and could provide a targeted contribution to economic growth and development. The strategy of a UK PRS fund will be likely to concentrate on geographic locations where there is a proven rental market, potentially combined with a shortage of quality rented accommodation, but focusing on the "mainstream" rental market to maximise the potential tenant base in each of these locations.

Certain parts of Greater London, selected towns in the South, South East and South West of the UK as well as major gateway towns and cities in the Midlands and North provide the potential locations for BtR developments. These are locations where there is already a proven demand for rental properties and which also offer quality living for workers, which is vital to promoting UK economic development and growth.

2. Long life and low risk of obsolescence

As shown in figure 1 below, the English Housing Survey 2014-2015, published by the Department for Communities and Local Government ("DCLG") stated that 82.4% (3.8 million properties) of all housing stock in the UK PRS (4.6 million properties) were built before 1990 and only 9.4% (431,000 properties) were built after 2003. Of the 82.4%, 49.2% (2.3 million properties) were built before 1945. This suggests that much of the existing UK PRS stock could be obsolescent and may not be truly fit for purpose.

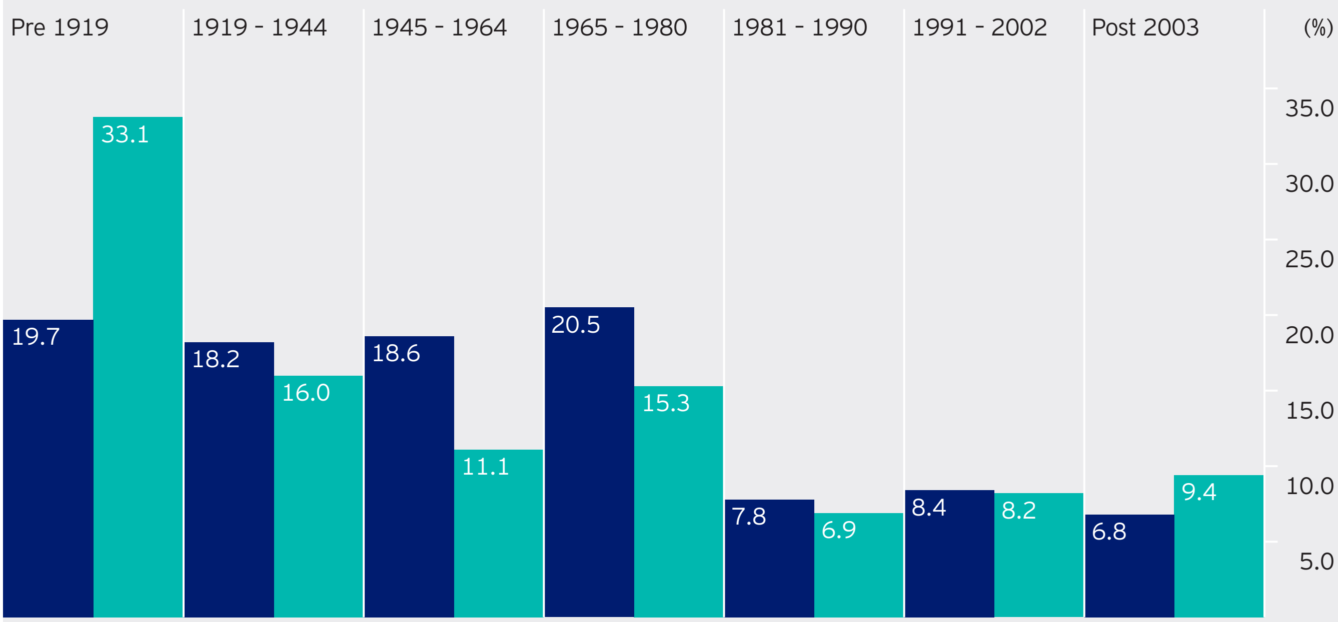
Quality, well designed newly built BtR assets are designed to have a physical long life and low risk of obsolescence given their modern designs. A BtR project (as shown in the photograph below) that has recently been completed for a LGPS and advised by Invesco Real Estate had a building design life of 60 years.

In addition, the dedicated on-site management teams who are employed in the blocks of flats in the portfolio on behalf of the Fund will assist in ensuring that the buildings are maintained to standards that will seek to extend its life through well programmed and regular maintenance programmes.

Gatefold BtR development, Hayes, London

Figure 1
English Housing Survey 2104-2015 – Dwelling age, by tenure, 2014

Owner occupied
Private rented



Source: Department for Communities and Local Government (DCLG), February 2016.

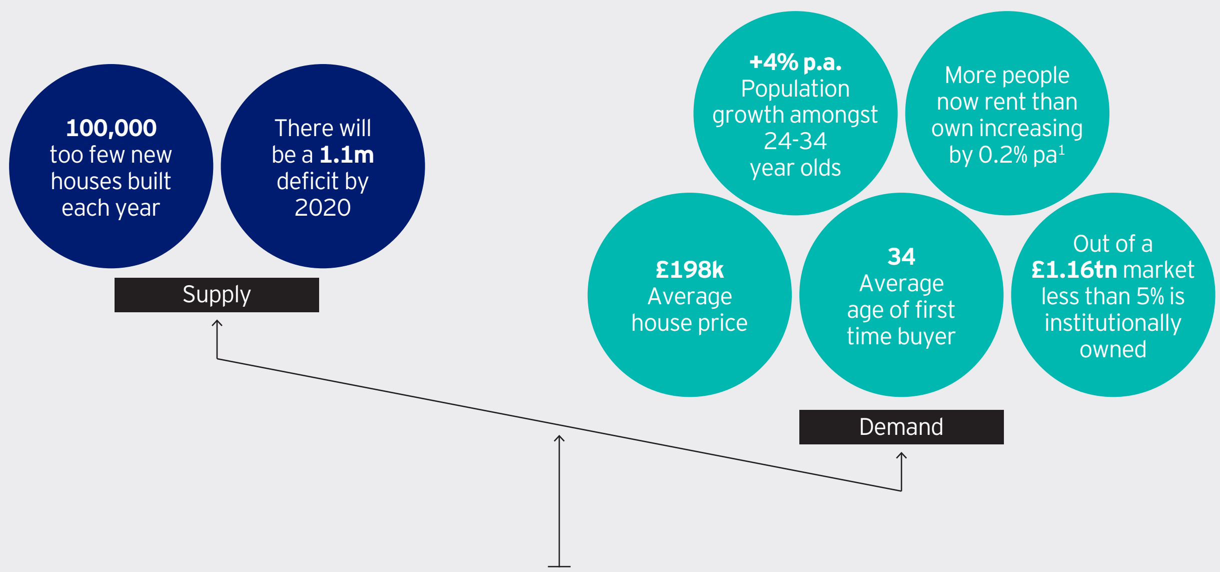
The UK is also facing a long running demand and supply imbalance in the housing market. Demand for housing continues to increase with supply failing to keep pace with an increasing population and the number of households being formed through changes in lifestyle choices (see figure 2 below).

Levels of (un)affordability, measured by the house price to earnings ratio, have reached historic highs meaning that many of those who are seeking to buy are unable to afford the deposits required to purchase a property, At the same time changes in aspirations for home-ownership in some age groups are further encouraging renting.

Both population growth forecasts and current projections on the supply of new build properties suggest that the strong demand for "build to rent" property will continue over the coming years. Therefore, institutional grade PRS funds are well-placed to take advantage of this demand as they grow their investment portfolios across the United Kingdom.

Based on current projections, these Funds should provide risk-adjusted returns over the long term to their investors, while at the same time positively supporting the functioning of society through the provision of quality housing.

Figure 2
Scales of opportunity
The supply/demand imbalance in the UK Residential market



Sources: Moody's analytics, Department for Communities and Local Government (DCLG), 1981 to 2015. Latest available data as of 30 September 2016. [1]1981-2012.

3. Identifiable and reliable cash flow, preferably either explicitly or implicitly inflation-linked

UK PRS funds can potentially provide long-term income to investors through the rents paid by tenants of the fund's assets under Assured Shorthold Tenancies ("AST"). These tenancy agreements provide the tenant with protection, whilst providing the investor with a contractual rent that is payable through the tenancy term.

Potential linkage to inflation (measured by the Consumer Price Index "CPI") can be seen in Figure 3 below which shows the relationship between CPI and the Index of Private Housing Rental Prices ("IPHRP") as published by the Office of National Statistics in November 2016.

Based on this data, over the time period measured (January 2006 to November 2016), the CPI grew on average at 2.3% per annum, London rents at 3.0% per annum, England excluding London at 1.7% per annum and England as a whole 2.1% per annum. It is also apparent that rental increases in all areas have been in excess of CPI over the last year.

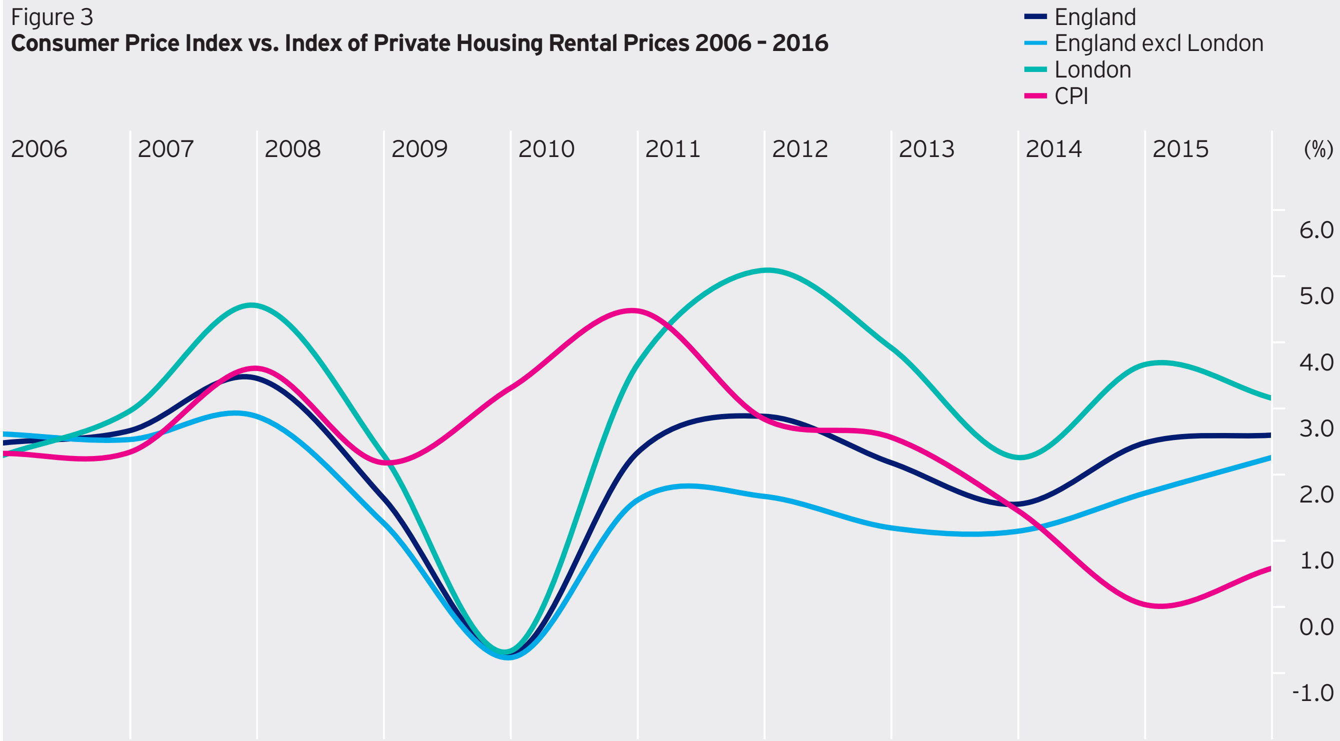
As the graph shows, all areas broadly move in line with CPI, suggesting that there is a good liability match in rental growth.

The weighting of a portfolio will ultimately define how closely correlated the returns are to the CPI.

A feature of UK PRS investment is also the early generation of income once the asset has been built as this occurs as the flats are let following completion of the development, with in some cases "pre-lets" being achieved to secure immediate income streams. As shown above, there is clear inflation linkage which is provided through the ability to periodically adjust rents (either on an annual basis or other contractual periods). Returns are also expected to be generated through capital growth, which further enhances the total returns that these investments can potentially generate.

Consequently, institutional UK PRS funds potentially have characteristics which are becoming more and more relevant to LGPS Funds as they continue to become increasingly mature.

Figure 3
Consumer Price Index vs. Index of Private Housing Rental Prices 2006 - 2016



Source: Office of National Statistics, November 2016.

4. Revenues largely isolated from the business cycle and competition, for example through long term contracts, regulated monopolies or high barriers to entry

Institutional quality UK PRS assets (and their revenues) are largely protected from the business cycle through investing in quality purpose-built BtR assets and the macro-economic conditions that exist in the UK Housing market.

The UK has experienced a long-term structural imbalance between the supply of new housing and the demand from households, which is not expected to materially improve in the coming years. Eight of the ten years from 2006 to 2015 saw more new households created than net increase in the housing stock. Cumulative housing under supply is predicted to almost double from approximately 600,000 to approximately 1.1 million from 2014 to 2020[2].

Figure 4 below shows housing starts from 1969 to September 2016 as analysed by DCLG. As at September 2016, there were 172,080 homes started in the 12 months preceding, compared to the long term average of 218,506 homes. This is 27% below the long term average for the UK as a whole. The same analysis for England stated that 141,740 homes were commenced against a long term average of 176,576 (25% below the average).

The affordability of house purchases (measured by the house price to earnings ratio) outside and particularly inside London is now at record highs and throughout the period since 2002 has remained above the long-term average (measured back to 1983). Even during the financial crisis of 2007-2010, these ratios did not fall below the long term average.

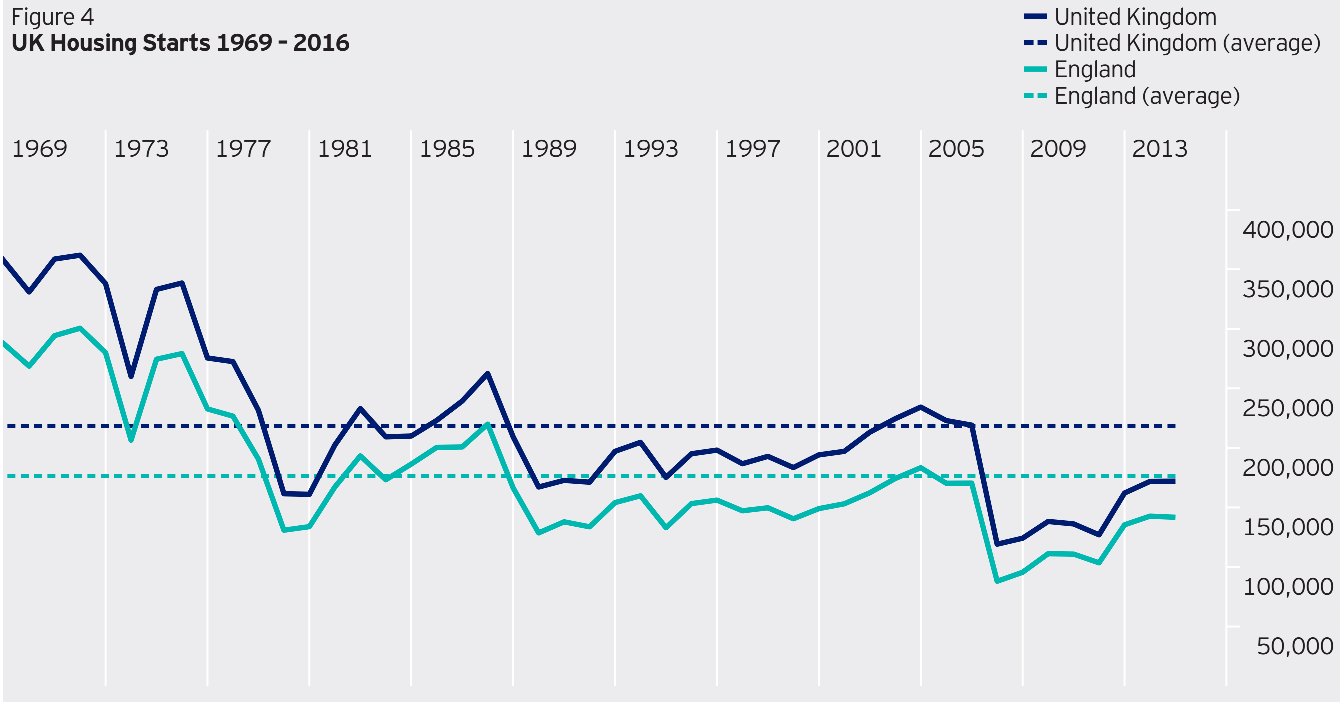
With such a strong supply demand imbalance in the UK housing sector the pressures on the market may assist in protecting revenues including rents from downward volatility even in future economic downturns.

The income generated in the PRS is based upon the Assured Shorthold Tenancies ("AST"), which provides the investor with contractual rent. Based on the Association of Residential Lettings Agent's November 2016 Private Rented Sector Report, the average length of ASTs in the UK is 18 months. Many institutional PRS Funds are looking to grant tenancy agreements of up to 3 years, providing greater length to the contracted income.

With the growing number of institutional PRS Funds it is expected that tenants will seek to secure the longest possible terms for their ASTs and so provide greater certainty on the long term nature of the income streams, which will benefit the tenants in terms of security and investors in terms of reducing void income periods.

2 Source: DCLG, Welsh Assembly Government, National Records of Scotland, NISRA and DCLG. Latest data available; as of September 2016.

Figure 4
UK Housing Starts 1969 - 2016



Source: Department for Communities and Local Government (DCLG), September 2016. The graph shows that whilst starts have been increasing from the historic low of 2008-2009, they are still considerably below the peaks of 2005-2006, suggesting that the under supply will continue.

5. Returns expected to show limited correlation to other asset classes.

Residential property is a separate asset class to commercial property and as highlighted in this paper, is a form of infrastructure. Residential property can be viewed as both a strong portfolio diversifier for many LGPS Funds and has historically provided superior risk adjusted returns.

Residential property has low correlations not only to core and value add commercial property funds but also listed equities and gilts as shown in Figure 5 below.

On a risk adjusted basis (Sharpe ratio), residential property performed better (to November 2016) than listed equities, core and value add commercial property over all of 3,5,10 and 15 years as shown in Figure 6 below.

The combination of the two sets of analysis suggests that UK PRS is a strong diversifier in a multi-asset investment portfolio.

Figure 5
Total Return Correlation Coefficient Matrix - 14 years to December 2015

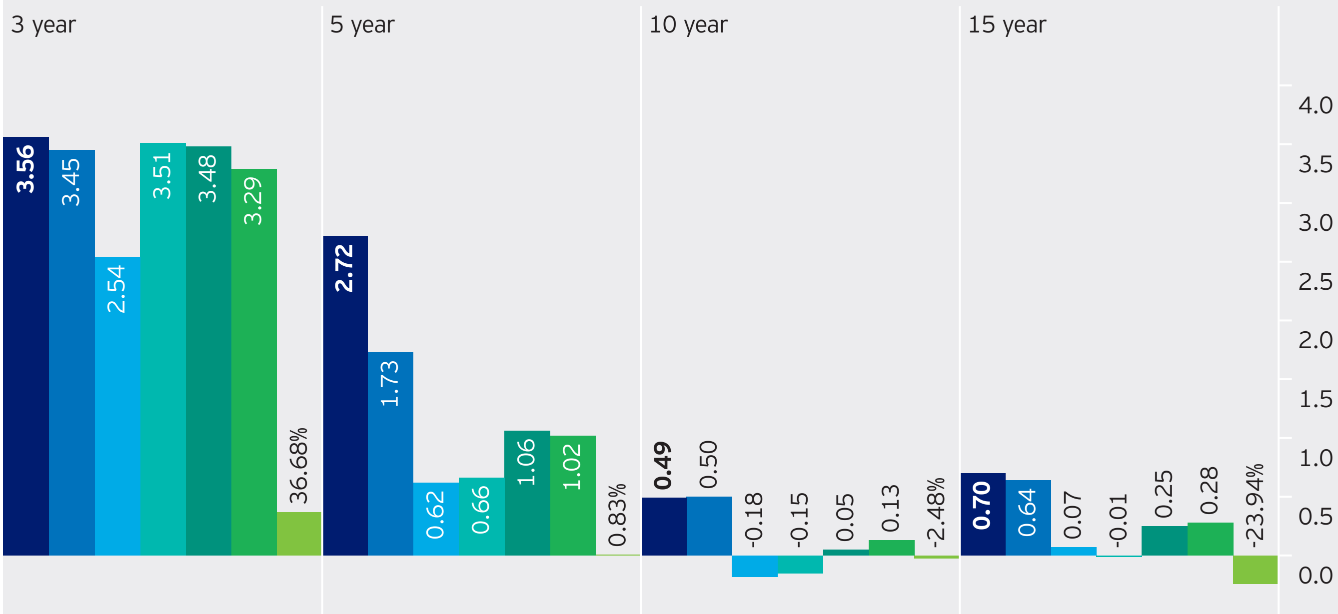
Real Estate Investment Strategies
Traditional Assets

	IPD UK Residential	IPD Europe Residential	Core Funds	Value Add Funds	IPD UK All Property	IPD Europe (ex. UK Resi)	Equities (FTSE All Share)	Gilts
IPD UK Residential	1.00	-	-	-	-	-	-	-
IPD Europe Residential	0.60	1.00	-	-	-	-	-	-
Core Funds	0.66	0.64	1.00	-	-	-	-	-
Value Add Funds	0.70	0.74	0.97	1.00	-	-	-	-
IPD UK All Property	0.66	0.57	0.98	0.96	1.00	-	-	-
IPD Europe All Property (ex. UK Resi)	0.73	0.86	0.93	0.97	0.91	1.00	-	-
Equities (FTSE All Share)	0.41	0.14	0.44	0.47	0.51	0.38	1.00	-
Gilts	-0.38	-0.04	-0.16	-0.23	-0.22	-0.15	-0.57	1.00

Source: MSCI and Macrobond as of December 2015, latest available data.
Diversification does not guarantee a profit or eliminate the risk of loss.

Figure 6
Sharpe Ratio Analysis

IPD UK Residential
IPD European Residential
Core Funds
Value Add Funds
IPD UK All Property
IPD Europe (ex. UK Resi)
Equities (FTSE All Share)



Sources: MSCI, Macrobond and INREV as of November 2016. Past performance is not a guide to future returns.

Conclusion

UK Private Rental Sector (PRS) or BtR investment – of which the Invesco Real Estate – UK Residential Fund is an example – have the potential to be an attractive infrastructure investment for LGPS Funds, helping to address both their investment challenges and the recently issued 2016 LGPS Investment Regulations and associated Guidance.

Alongside BtR investment's identifiable and reliable cash flow characteristics, it can potentially enhance long-term portfolio diversification through its expected low correlation with UK equities, gilts and commercial real estate and help LGPS Funds mitigate funding pressures from ongoing public sector funding constraints.

Overview: Invesco Real Estate – UK Residential Fund

The Invesco Real Estate – UK Residential Fund ("the Fund") can provide LGPS Funds access to 'UK infrastructure' investment that we believe is consistent with the LGPS Cross Pool Collaboration Group's definition of infrastructure. The Fund is underpinned by several key factors which include:

1. The Fund is managed by a dedicated team with significant experience of both investing in and managing Build to Rent (BtR) assets.
2. Invesco has been investing in residential investments in the United States for over 30 years and this compliments the skills of the UK based team who are also able to call upon the experience of the US team in this sector.
3. The Fund is presently open to investors with a number of assets currently under development with others at various stages of due diligence.
4. The Fund's strategy is to invest in whole blocks of flats which have been designed specifically for the purpose of "BtR" with the primary target market 24-35-year-old renters.
5. Environmental, Social and Governance considerations are fully integrated throughout the process, from acquisition planning, development to ongoing property management.
6. The Invesco Real Estate team sees particular value in parts of Greater London, selected towns in the South, South East and South West of the UK as well as major gateway towns and cities in the Midlands and North. These are locations where there is already a proven demand for rental properties and which also offer quality living for workers, which is vital to promoting UK economic development and growth - and where the cost of constructing BtR assets combined with a diversified employment base are potentially resilient to any economic slowdown.
7. The levels of rent in the Fund are expected to provide consistent cash flows, targeting net yields of circa 4.0% per annum on the stabilised assets.
8. The Invesco Real Estate team has existing experience of meeting the needs of the LGPS with the Fund having already secured investment from a number of LGPS Funds.

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Important information

All data as at end November 2016, unless otherwise stated.

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