Levelling Up and the UK Build to Rent Sector – an opportunity for the Local Government Pension Scheme?

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Summary

There is consensus that there is a significant shortfall of good quality, affordable housing in the UK. Whilst the Government has set a target to deliver 300,000 homes per annum, this is consistently not being met.

The recent Levelling Up White Paper, published in February 2022, looks to increase investment in housing across the UK – including from the private sector. In this note, we argue that Build to Rent (BtR) as an asset class is well-placed to align with this agenda. With a lack of supply and affordability concerns, the number of private renters is growing in the UK, with circa 98% of stock currently owned by small, non-professional landlords.[1] BtR supports the Government's goal to improve not just the quantity but also the quality of accommodation, allowing for the creation of thriving communities across the UK.

As one of the largest, most mature "residential" sectors, BtR offers stable, monthly income from a well-diversified tenant base. BtR investments offer the ability to put capital to work efficiently and deliver long-term investment returns to pension funds through an environmentally and socially sustainable investment strategy.

This paper covers:

- What is levelling up and how does it support residential investment?
- The opportunity in Build to Rent
- Environmental, Social and Governance
- Conclusions

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What is levelling up and how does this support residential investment?

Since the 2019 General Election, increasing the supply of housing has become an important feature of the Government's plans both to 'Build back better' from the Covid-19 pandemic and to 'Level up' the country by reducing geographical inequalities within the UK across a wide range of factors.

The *Levelling Up White Paper ("White Paper")*, published in February 2022, identified that housing has "a critical role in delivering the outcomes that levelling up aims to achieve across the UK".[2]

Importantly, the White Paper emphasised the importance not just of quantity but also quality, stating:

"The importance of housing goes beyond its availability. Having a decent home is fundamental to our well-being and housing quality must be addressed in order to create thriving neighbourhoods and communities."

While the shortage of *social* housing is a key area of focus in the White Paper, it also notes the importance of the Private Rented Sector, observing that the sector has doubled in size over the past two decades.

At the heart of the proposed Levelling Up policy regime for government are a series of medium-term missions, intended to act as policy drivers across Whitehall.

In relation to housing, according to the White Paper, the Government's mission is that by 2030, "renters will have a secure path to ownership with the number of first-time buyers increasing in all areas; and the government's ambition is for the number of non-decent rented homes to have fallen by 50%, with the biggest improvements in the lowest performing areas."

What is Levelling Up?

The term 'Levelling Up' wasn't officially defined until the Government published its White Paper in February 2022. In it, Levelling Up is summarised as spreading opportunity equally, ending geographical inequality and encouraging private sector investment right across the UK so that everyone can share in the country's success. The Government believes success in this mission could yield a significant economic prize, boosting aggregate UK GDP by tens of billions of pounds each year.

The Almere, Milton Keynes

Government looks to pension schemes to invest

In the wake of the pandemic and the almost unprecedented peacetime shock to the UK economy, the Government is increasingly looking to mobilise alternative sources of investment to finance its infrastructure and levelling up ambitions.

In a letter to institutional investors in August 2021, the then Prime Minister and Chancellor called on institutional investors and their advisers to ignite an "investment big bang" by committing to invest a greater proportion of their capital to long-term UK asset classes.

Building on this, the White Paper identified the "huge potential for institutional investment to support levelling up, across infrastructure, housing" and other areas.

Specifically, the White Paper identified the Local Government Pension Schemes (LGPS) as a potential source of institutional funding. The Paper argued that, as (collectively) the largest pension scheme in the UK, if all LGPS Funds were to allocate 5% of their AUM to "local investing", this would unlock £16bn in new investment (the definition of "local investing" was subsequently clarified by the Local Government Pension Scheme Advisory Board as meaning 'in the UK'[3]).

Consequently, the Government intends via a future consultation to ask LGPS funds to publish plans for increasing local investment "including setting an ambition of up to 5% of assets invested in projects which support local areas."

The opportunity in BtR – Political consensus on the need to build more new homes

According to government targets, the UK requires 300,000 homes per annum in order to meet occupier demand, a figure that has not been met in a number of years, thus creating an estimated cumulative shortfall of 1.1m homes as at December 2020.

The continued growth in demand for housing and the decline in affordability is increasingly pushing housing higher up the political agenda. At the last General Election in 2019, both the Labour and Conservative General Election Manifestos recognised the shortage of homes and committed to take steps to increase supply, with the Conservatives pledging to "build at least a million more homes, *of all tenures*, over the next Parliament".[4]

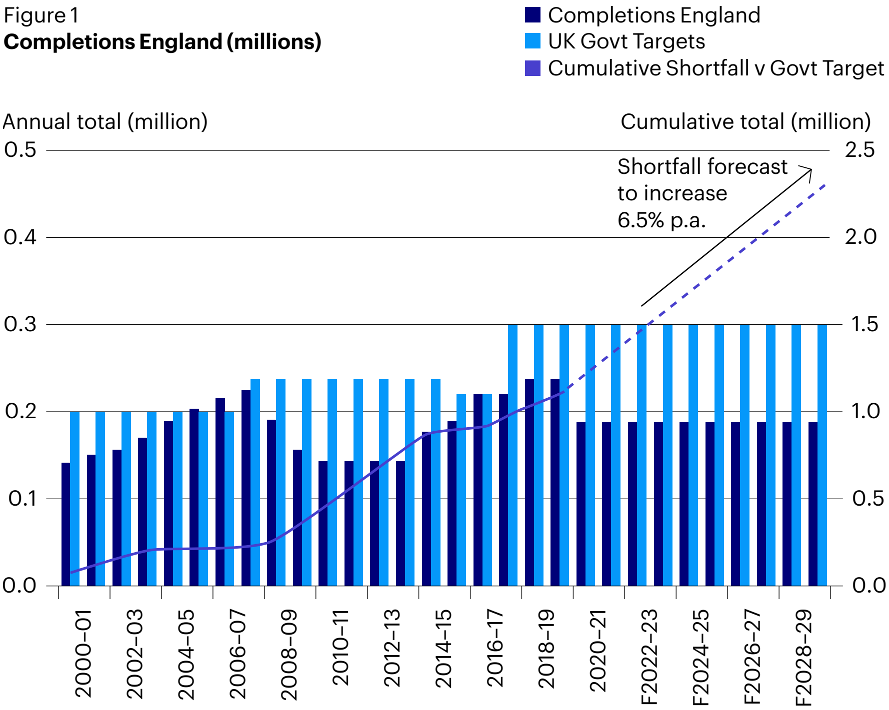
As LGPS Funds consider how best to take forward the Government's expected request to produce plans that fulfil the ambition of allocating to assets in 'local areas', it's clear that investing in housing across all tenures could play an important role and deliver investment returns.

As a relatively immature sector from an institutional investor perspective, it is important to understand the various dynamics of the residential sub sectors such as social, affordable, open market BtR and later living, for example, in order to align achievable returns with investor requirements. As explored above, there is a need for housing supply across the spectrum, but the return outcome either through income or capital growth can vary significantly. Additional factors such as liquidity and capital deployment which will affect the investor experience in terms of cashflow and return outcome should also be considered.

Flowing from the Levelling Up White Paper, in June 2022 the Government published its *Private Rental Sector White Paper ("PRS White Paper")*. The PRS White Paper emphasises that the Government is "committed to levelling up quality across the board in the Private Rented Sector", noting that PRS still provides a vital home for students and young professionals, as well as a rising number of other demographics.

> BtR is the largest sector within the residential asset class to see institutional investment.

Figure 1
Completions England (millions)



Source: Hometrack, MHCLG and Invesco Real Estate, as of March 2022

Currently, the need for rental accommodation is most widely felt in urban areas where suitable supply is most limited. The main demand by demographic has traditionally been professionals and key workers who are yet to save enough for a deposit on a home and thus enter the rental market close to their employment and other amenities. Combined with investors' need to generate an attractive, inflation-correlated return from a well-diversified set of tenants, the open market BtR sector was first to see institutional investment shortly after 2010 (e.g., Get London Living and Olympic Village). As a sector that has grown significantly in that time, it increasingly serves a wide proportion of society and, as a result, BtR is the largest sector within the residential asset class to see institutional investment. In turn, this offers scalability, capital deployment, diversity of underlying tenant base and attractive returns vs other asset classes.

Other residential sub sectors that have the ability to provide similar features in time are much further behind in terms of maturity. Investors looking at these areas should be aware of this and that by investing in a relatively smaller sub asset class they will experience a corresponding return that factors in a development J-curve, capital deployment delays and volatile valuations given the size of the market.

To provide context, there are still relatively few transactions in the BtR market where stabilised assets are sold because the majority of investors who have developed these assets hold them for the long-term income streams that they generate. To engage in a significant residential investment program, it is currently necessary to develop institutional grade assets that institutions would like to hold over the long term. The goal, once developed, is to manage assets efficiently to provide a consistent income stream supported by capital growth over the medium to long term. Ultimately the BtR sector can potentially fulfil both the Levelling Up agenda and LGPS investment needs because it has the ability to meet LGPS requirements for an attractive risk-adjusted total return that complements a multi asset class portfolio whilst investing in high-quality, additional homes "locally".

Environmental, Social and Governance

Currently, in the UK, 98% of the PRS is owned by small "Buy to Let" or non-professional landlords.[1] As mentioned above, the Levelling Up agenda identifies the need to improve the quality and quantity of available homes by 2030. Institutional ownership of BtR is well-placed to deliver this through environmental responsibility, consideration of social factors and good/strong corporate governance.

The Copper House, Liverpool

There are many ways to put ESG considerations into practice, including the following three examples:

1. **Higher energy efficiency.** Typically, newly developed BtR assets have much higher EPC ratings, which in the case of an A, B or C rating could save the average tenant £3,246p.a. or £270p.m compared to a lower quality G rated property typically found in the wider residential rental market (based off published energy prices post increase on 1st April 2022).
2. **Socially responsible landlords.** The Pandemic was a particular example where the social responsibility of landlords in the BtR sector was crucial to ensure the wellbeing of occupying tenants and the health of the community. Onsite staff were able to "check in" during the Pandemic lockdown with isolated or vulnerable individuals to identify issues such as mental/physical health or financial security challenges, which was essential to ensure support was given where needed. Examples of this were community engagement, the delivery of care packages and financial flexibility.
3. **Responsible governance.** Good governance provides a better experience for tenants. Recent government proposals to protect tenants from eviction are a reflection of poor management of BtR by non-professional landlords. By contrast, the owners of purpose-built, institutional grade assets intended for long-term occupation are incentivised to retain tenants and maintain the quality of accommodation to ensure a consistent income. Through the Pandemic, for example, it was possible to work with tenants to ensure payment plans were put into place with the ultimate goal of tenant retention over the long term. Non-institutional landlords may not take such a professional approach to their tenants.

Conclusions

For LGPS Funds, we believe the merits of investing in private residential BtR homes aligns with both the Government's Levelling Up agenda and the investment requirements of the LGPS. It has the potential to help address the UK's severe housing shortage while simultaneously delivering a positive and reliable income stream to meet future pension liabilities, alongside capital appreciation opportunities.

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The development and operation of quality new homes for rent will continue to be urgently required to meet the ongoing demand for housing.

Such is the gap between the supply and demand for housing, together with ongoing affordability challenges, that the Government's plans to extend home ownership cannot realistically be the only major solution to the UK's long-standing and acute housing shortage.

In summary, supply, affordability and Government policy, as well as consumer choice, mean that the development and operation of quality new homes for rent will continue to be urgently required to meet the ongoing demand for housing.

UK BtR housing has a number of characteristics which may make it an attractive investment for LGPS Funds. This is particularly the case as LGPS Funds seek to diversify their investment strategies to increase capital stability and reduce equity-related risk, while maintaining exposure to assets which should generate returns that exceed the likely assumptions in the 2022 LGPS Actuarial Valuations.

Residential BtR offers the potential for stable investment returns that the LGPS, as an open defined benefit scheme with a 1/49 future service accrual rate, will require going forward. In addition, the changing maturity and cashflow characteristics of the LGPS (which we believe will continue) requires an increasing focus on long-term, reliable inflation-linked returns, in addition to capital growth characteristics.

We believe that focused UK BtR housing can support the LGPS in its pursuit of investment returns to meet its liabilities and pay existing pensions – and do this in a manner which can have a positive impact on local communities across the UK.

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Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Property and land can be difficult to sell, so investors may not be able to sell such investments when they want to. The value of property is generally a matter of an independent valuer's opinion and may not be realised.

Important information

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References

1. Knight Frank Research, January 2022.
2. DLUHC, Levelling Up the United Kingdom, February 2022.
3. LGPS Scheme Advisory Board (lgpsboard.org).
4. Emphasis added. Conservative Party, 2019 General Election Manifesto. The three main tenures groups classified by the Government are: owner occupiers; private renters and social renters.