



Social Real Estate

A £50 billion secure income opportunity?

Part of Alpha Real Capital's Cashflow Driven Investing series

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Alpha Real Capital

The widening focus of ESG

The appetite for real estate investments with positive Environmental, Social and Governance (“ESG”) characteristics has grown significantly over the past decade, consistent with the trend seen across the asset management industry. Over 90% of real estate investors now include ESG criteria in some form when making investment decisions¹. With the built environment being responsible for 40% of energy consumption across the EU², the focus to-date has been weighted towards the ‘E’ of ESG, improving the environmental aspects of buildings being acquired, developed and operated.

However, investors are showing increasing awareness and interest in moving beyond just opportunities which ‘do no harm’, to also embrace those which actively deliver a greater purpose and value to society, focusing increasingly on the social aspects of their chosen strategies. Indeed over 70% of people in the UK say they not only want their investments to avoid causing harm but also to achieve good for people and the planet, reflecting a growing trend of socially responsible and sustainable investment³ that investment managers and consultants are looking to mirror in their allocations and strategies.

To align with these objectives, investors are starting to look outside of the traditional real estate sectors to a range of alternatives – including social real estate – which can deliver not only attractive risk-adjusted returns and secure, long-term income, but also meaningful social and societal benefits.

A ‘perfect storm’ of demographic drivers, supply shortages and funding limits currently exist, underpinning a scale opportunity that can deliver attractive risk-adjusted returns and align with investors’ socially responsible and sustainable investment aspirations⁴.

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Key take-aways

Secure income assets can deliver high-quality, inflation-linked cashflows and attractive returns. With strong investor appetite for these assets, looking outside the established sectors for the next big opportunity could both unlock value and support the swift capital deployment of secure income allocations.

Social Real Estate could be just that opportunity, offering investors:

- **Favourable market dynamics:** a ‘perfect storm’ of structural demographic demand, coupled with inefficient and insufficient stock, underpins an urgent need for capital investment. With public finances stretched, private capital will be needed to support the delivery of assets across housing, healthcare and education sectors – an opportunity that could be over £50 billion.
- **Tangible ESG benefits:** investments in Social Real Estate can deliver quantifiable societal benefits, satisfying investors’ Social targets as part of ESG and SRI strategies – a diversified portfolio could deliver £3-4 of social value for every £1 invested.
- **Very compelling investment outcomes:** a multi-sector Social Real Estate strategy could deliver high-quality, long duration, inflation-linked cashflows at spreads of 5%+ p.a. over comparable index-linked gilts.

1 UNEP FI – Global ESG Real Estate Investment Survey Results, 2019

2 European Commission – Energy Efficiency in Buildings, 2020

3 HM Government – Investing in a Better World, 2019

4 Including pension funds’ Statements of Investment Principles (SIP) where environmental and social considerations are disclosed

Real estate assets with societal benefits

Social real estate (“SRE”) comprises physical assets across a range of sectors, which accommodate or facilitate social activities or services, delivering positive outcomes for the people and communities that those assets serve. Broadly, they fit into the groupings of housing, healthcare and education. These broad groupings include a variety of asset types, such as:

Housing	Healthcare	Education
<ul style="list-style-type: none"> ● Senior living / retirement ● Extra care ● Affordable housing including key worker ● Student ● Homelessness ● Specialised supported 	<ul style="list-style-type: none"> ● Care homes ● Specialist care homes ● Primary care ● Secondary care ● Private treatment / specialist clinics 	<ul style="list-style-type: none"> ● Day nurseries ● Primary, secondary and Special Educational Needs and Disability facilities ● College or university faculties

Source: Alpha Real Capital

The assets perform the dual function of providing tangible societal benefits whilst concurrently delivering long-term resilient income streams that are less volatile than cyclical economically-correlated sectors, since they are underpinned by an essential need rather than an optional desire. They are a critical component of building stronger, better communities.

Social real estate is diverse in nature, reflecting the diversity of societal needs – but the assets share a common purpose of supporting communities and those in need, are economically linked to public sector funding either directly or indirectly and offer similar investment characteristics. The assets also share a common set of demographic drivers, supply challenges and financial pressures, which contribute to a compelling opportunity when viewed collectively.

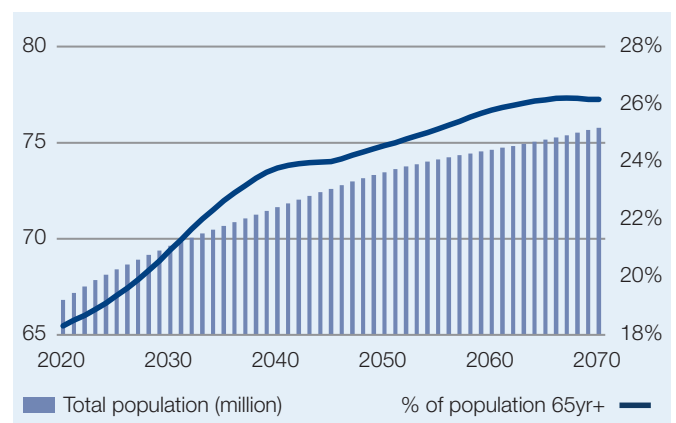
Long-term demographics underpin structural demand

Demand for SRE assets and the services provided within them is structural and not cyclical, underpinned by a population which is both growing and ageing. The UK population is forecast to increase by c.3 million in the next decade, reaching c.70 million⁵, placing further demand on assets and services which are already at or near capacity. Overall population growth will require additional facilities across the whole social real estate spectrum from day nursery places, primary and secondary education facilities to GP surgeries, the wider healthcare sector and housing.

But the cohort expected to see the largest growth are those aged 65 or over. Over the next decade this group will grow by c.3 million, meaning that one in five people in the UK will be aged 65 or over⁶. Whilst improved life expectancy and the period of active work and life have increased, this age group are the dominant users of care and medical facilities. More than 4 million have a serious long-term health condition, 3 in 10 are no longer in good health and 1.5 million have an unmet care need⁷.

As they grow in number there will be a marked increase in demand for social assets and services across all care and accommodation sectors.

Figure 1: UK population growth forecast



Source: ONS National Population Projection (2018-based), 2019

5 ONS – National Population Projections, 2018

6 Age UK – Later Life in the UK, 2018

7 Age UK – Parliamentary Briefing: Social Care Reform and General Election Manifesto, 2020

Capacity and quality limitations highlight funding requirements

Whilst population growth and an ageing demographic will drive increased demand for SRE assets and services, there is an immediate requirement for investment resulting from the combined challenge of capacity limits (insufficient stock) and quality or operational limits (inadequate stock). The growing and ageing population will simply exacerbate issues already being faced.

Some of the most acute capacity challenges currently observed are in the housing sector, exemplified by the 141% increase in rough sleepers between 2010 and 2019⁸, the continued rise in households in temporary accommodation (c.87,000), up 82% since 2010⁹, and the 1.6 million households on housing waiting lists¹⁰.

Capacity issues can be seen across the education sector. 17% of secondary schools are over capacity, as are 20% of primary schools¹¹ and there is a shortfall of over 8,500 places for children and people with special educational needs and disabilities¹². Similarly in the healthcare system, waiting lists for treatment, already rising due to a lack of capacity, now face a growing backlog resulting from the COVID-19 pandemic that could see 10 million patients waiting for treatment by the autumn¹³.

Quality or operational limits often result from the use of older, non-purpose-built stock which may no longer be fit-for-purpose. For example, only half of GPs consider their premises adequate for present needs, with just 2 in 10 expecting their practices to be fit for the future in respect to population growth¹⁴. Similarly, by one estimate, a third of UK care homes could close over the next 5 years¹⁵, comprising older, smaller and less efficient non-market standard properties.

The inadequacy of existing SRE assets has become more acutely visible during the COVID-19 pandemic – from GP surgeries without the space and facilities for video appointments, to care homes unable to practice effective infection control due to a lack of isolation rooms or en-suite shower facilities. Whilst post-pandemic, a degree of normality will resume, the new ways of operating that were required during this period will undoubtedly filter into the design of future social real estate and best-in-class standards, effectively accelerating the rate of obsolescence in older, non-purpose built stock, requiring even greater levels of investment.

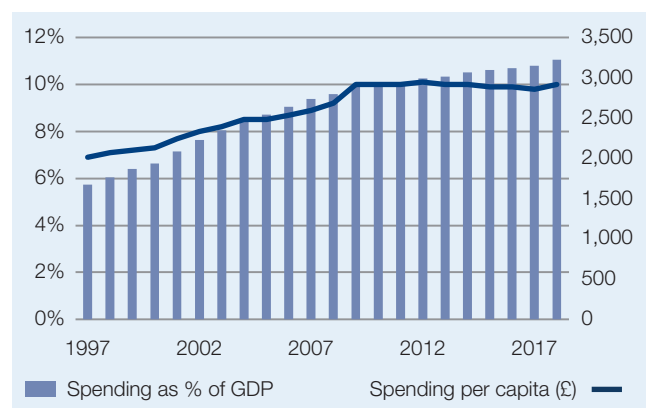
Stretched public sector finances forced to focus on essential services

Despite a growing awareness of the rising demand and capacity and quality challenges of social assets, particularly within the healthcare and social care sectors, public sector funds are already under pressure or being cut. This situation has been exacerbated by the immediate responses to support communities during the COVID-19 pandemic. At a national level, public sector net debt exceeded 100% of GDP in May 2020 – the first time it had done so since 1963 – and has continued to grow, exceeding £2 trillion by July 2020¹⁶. Meanwhile at a local level, a ‘perfect storm’¹⁷ is emerging, with local authorities expected to face a financial hit equal to 13% of pre-crisis expenditure in 2020-21 alone.

The focus at both a national and local level will therefore be on maintaining essential services, with little (if any) capacity to develop, expand and improve facilities to accommodate future capacity. Healthcare expenditure spending has already increased by over 80% on a per capita basis over the last 20 years, reflecting the rising costs of delivering care, an increase in chronic conditions and an ageing population. Surprisingly, the figure has stagnated as a proportion of GDP – perhaps reflecting the impact of austerity measures and suggesting unfilled demand that is beginning to show. A recent report assessing the NHS estate, by example, highlighted a

£6.5 billion backlog in maintenance of the existing estate, £1.1 billion of which was high risk¹⁸.

Figure 2: UK Public expenditure on healthcare



Source: ONS, OECD

Similar financial pressures are evident across the majority of SRE sectors. This resulting opportunity is significant, arising from a necessity for private capital to step in and accelerate the delivery of modern, fit-for-purpose and operationally efficient SRE assets needed to facilitate quality services and positive outcomes in future.

8 MHCLG – Rough sleeping snapshot in England, Autumn 2019

9 House of Commons Library – Households in temporary accommodation (England), 2020
10 National Housing Federation – People in Housing Need, 2020

11 Department for Education – School Capacity in England: academic year 2018/19, 2020

12 National Education Union – Send Crisis as at January 2019

13 NHS Confederation – nhsconfed.org/news/2020/06/road-to-recovery, June 2020

14 BMA – GP Premises Survey Results, 2020 (late 2018 survey)

15 Knight Frank – EG News, 26 May 2020

16 ONS – Public Sector Finances UK, July 2020

17 IFS – COVID-19 and English council funding, August 2020

18 NAO – Review of capital expenditure in the NHS, February 2020

Attractive characteristics and resilient performance should attract capital

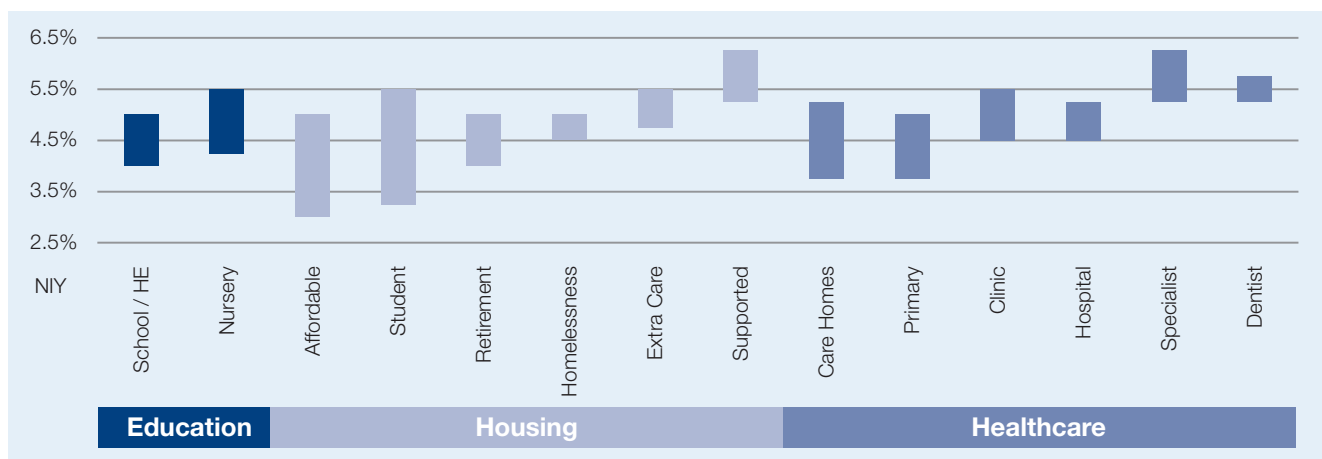
This opportunity should encourage capital flows, attracted by the characteristics SRE investments can offer. These operational assets address long-term demand requirements and, as such, tenants are willing to take leases of 20 to 25-year terms or more. This compares favourably to the average commercial property lease which is less than 10 years. With tenants' income in many instances coming from local or central Government, there is a tendency to align lease rental obligations with the funding source – annual CPI reviews are therefore common, providing long-term inflation-linked cashflows that are increasingly sought after.

The presence of Government / quasi-Government tenants can help to reduce counterparty risk, ranging from direct local or central Government leases at the most secure end, through to smaller, less established operators such as Registered Providers who act as

conduits for public funding. SRE sectors as a whole offer a greater degree of certainty of rental payment, given the long-term, growing demand for the accommodation and essential services being provided, unlike the cyclical demand-driven traditional real estate sectors.

This resilience has been recently evidenced by strong rent collection rates – and therefore income returns – during the COVID-19 crisis. By example, according to CBRE, care home rent collection rates were 96.8% in June 2020, compared to the all-sector collection rate of 80.6%¹⁹. Similar patterns were reported by specialist REITs and investment managers exposed to other SRE sectors including primary care and specialised supported housing. This has been reflected in resilient valuations and the removal of Material Uncertainty Clauses from valuations ahead of more traditional real estate sectors where occupier stress was more acute.

Figure 3: SRE sector pricing

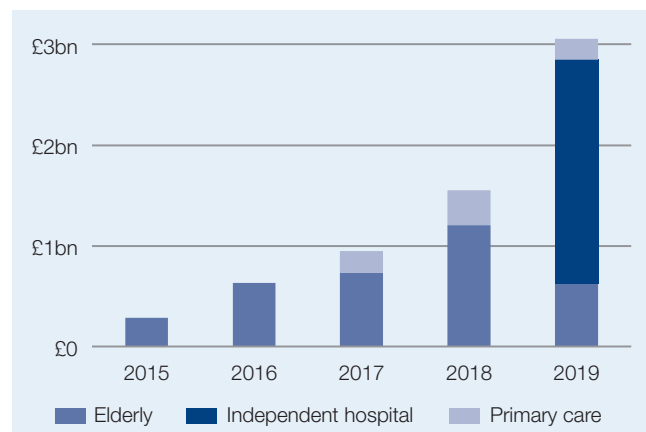


Source: Alpha Real Capital, market observed pricing as at June 2020

SRE investments therefore offer long-term, predictable and inflation-linked income streams in sectors experiencing positive, structural rather than cyclical, supply-demand dynamics as well as being less exposed to the short-term cyclical changes experienced by many other real estate sectors. With a significant yield pick-up compared to investing in index-linked gilts or swaps and initial yields ranging from 4-6% on average, investment activity – which has already seen substantial growth, as evidenced by healthcare investment volumes below – is expected to increase for the foreseeable future.

With SRE sectors currently priced at a significant spread (c400-500bps) to equivalent gilts, an aggregated portfolio appears well placed to deliver on both inflation-linked secure income requirements and investors' non-financial returns requirements.

Figure 4: UK healthcare investment volumes



Source: Savills – UK Healthcare Real Estate, Q1 2020

Note: for context, overall investment volumes in the UK in 2019 were estimated at c.£50bn.

The importance of development and diversification

Due to the growing need to replace inadequate stock, SRE investments frequently comprise developments either on a forward funding or a forward commitment basis. Whilst this can extend the period of capital deployment, the ability to participate in their origination enables investors to influence investment characteristics, ensuring the long-term viability of the assets and their affordability by the tenants, thereby underpinning genuinely long-term values. Supply generation through forward funding also maximises social benefit, by creating rather than repurposing existing stock (e.g. historical conversion of residential to medical reduced available housing stock) that is already in demand.

Similarly, adopting a flexible, multi-sector strategy that recognises the communalities of the sectors – such as Government funding sources, demographic drivers and lease characteristics – enables the aggregation of a portfolio at scale, overcoming the perception of SRE investment as a series of discrete, niche opportunities. It also lets investors move between sectors as new opportunities emerge or retreat over time, investing where risk-adjusted returns are most favourable, capturing diversification benefits and also ensuring the ability to continue to deploy capital throughout cycles.

SRE represents an untapped £50 billion+ investment opportunity

Whilst a number of specialist REITs and responsible or impact funds have already deployed capital into SRE, an assessment of the SRE sectors shows that the scale of the investment opportunity is large and significantly untapped.

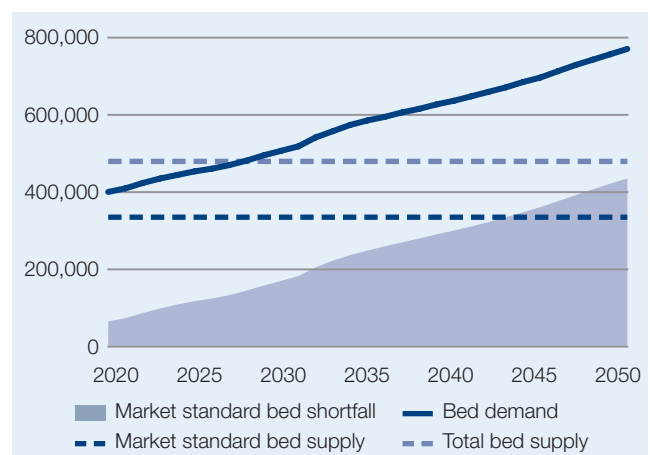
For example, the unsatisfied requirement for specialised supported housing is currently around 45,000 units²⁰. Taking a conservative capital value assumption of £175,000 per bedspace for the development of new accommodation to meet that demand (based on average rents and investment yields observed across the sector), the capital required would amount to £8.0 billion.

Analyses of other SRE sectors show similar – frequently larger – scale investment requirements. The replacement of smaller care homes or those with non-market standard facilities (shared bathrooms, for example) could alone require £6 billion of funding. An even greater sum would be required to develop sufficient homes required to meet a forecasted 300,000 bed shortfall by 2050 that the UK's ageing population demographic will require.

Equally, the primary care investment requirement to replace existing GP practices considered not fit for purpose is estimated at £17 billion or more before population growth is factored in. Homelessness and temporary accommodation solutions could require more than £10 billion whilst a day nursery shortfall may be of a similar magnitude.

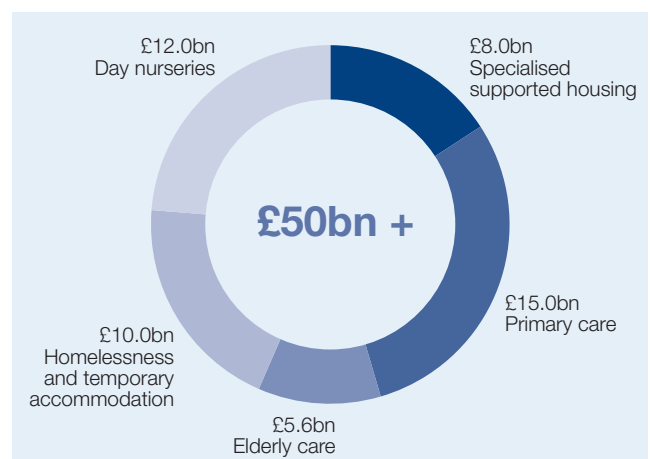
Even based on conservative assumptions, this represents a £50 billion+ opportunity across all of these sectors. Looking at statistics for the wider SRE universe, the opportunity could easily be a multiple of this. Investors seeking to deploy institutional scale capital over the medium to long-term can therefore be confident of being able to do so across a range of sectors with similar characteristics, achieving sectoral diversification and securing assets that have shown remarkably resilient performance.

Figure 5: Long-term shortfall in market standard care home bed provision



Source: Knight Frank, ONS, Laing Buisson, caredata.co.uk (Tomorrow's Guides)
Note: estimated demand based on ONS population forecasts with supply frozen at current levels

Figure 6: Investment required



Source: Alpha Real Capital

ESG performance and benchmarking could enhance allocations

Investment allocations naturally reflect a mix of financial return requirements and non-financial considerations including diversification to mitigate risk or allocations factoring in environmental impacts or social benefits. There is an increasing acknowledgement that these non-financial considerations do not have to come at the expense of financial performance.

Whilst the positive social characteristics of assets may not always enhance the overall return, the role social real estate assets play within communities enhances the resilience of returns, since they are essential to the residents and communities they serve. The resilient performance of SRE assets to date during the COVID-19 pandemic has evidenced this.

Whilst financial returns can be measured across sectors and between asset classes, providing a clear comparison, non-financial benefits can be more difficult to assess. SRE can deliver on more qualitative measures, such as the UN Sustainable Development Goals relating to people (good health and wellbeing: healthy lives and promoting wellbeing for all), and peace (sustainable cities and communities), as well as delivering favourable risk-adjusted returns.

However, a standardised approach to the measurement of non-financial performance and outcomes remains a challenge. The emergence, evolution and adoption of standards to quantify and compare the relative social and governance merits is expected to increase over the next few years. Emerging benchmarking tools such as the Social Profit Calculator have developed methodologies to quantify social value outputs and social return on investment metrics across a range of sectors.

These improvements in benchmarking, coupled with increasing regulatory requirements (such as pension fund SIPs) and stakeholder pressure to invest responsibly – and the ability to evidence positive non-financial outcomes – are expected to heighten investment into SRE. Accordingly, as demand for responsible investment strategies grow and traditional real estate sectors face cyclical demand challenges, capital inflows into SRE should strengthen.

SRE outlook - the next big opportunity in secure income

SRE assets have strong demographic underpins which support the quality of the long, secure inflation-linked income streams, many of which are directly or indirectly linked to public sector income, with tenants exhibiting a high propensity to pay rents.

A significant opportunity exists to deploy capital at scale across a diversified range of assets, delivering both strong risk-adjusted financial returns and positive non-financial returns. Advances in the ability to quantify and measure non-financial returns will encourage further allocations to the sector, as will recent robust income returns and valuations during a period of economic disruption.

Through adopting a diversified investment strategy and stock selection focused on fit-for-purpose assets, there is a significant opportunity to build better, stronger communities whilst also delivering positive outcomes for tenants, service users and investors alike.

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Alpha Real Capital LLP is a specialist real assets investment manager focused on secure income strategies. We invest in UK and European assets with predictable secure long-term cashflows to help our clients meet their liabilities.

We provide market leading and innovative real asset solutions across a range of investments such as commercial ground rents, UK renewable infrastructure, social real estate and lifetime mortgages, combining operational real estate expertise and fixed income skills.

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Contact Alpha Real Capital

Please get in touch with your usual Alpha Real Capital representative or contact:

Hattie Walton

+44 (0)207 391 4568

hwatson@alpharealcapital.com

Alpha Real Capital

For more information about Alpha Real Capital LLP, its funds and key personnel visit: www.alpharealcapital.com

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