Putting the 'S' in 'ESG' – investing in social infrastructure

Key messages

- Many investors have focussed their Responsible Investment efforts on climate issues, with social impact being considered too difficult. Social infrastructure is an asset class with the dual ability of achieving social impact whilst achieving strong returns.
- Social infrastructure is investing in real estate assets that are integral to the functioning of society, supporting the quality of life and wellbeing of communities. Examples include schools, doctors surgeries and housing.
- With the ability to earn returns and have a positive impact come risks, both financial and non-financial. These must be seriously considered before making an investment.

Introduction

Infrastructure and real estate have long been investment mainstays. They've generally been favoured for their strong return potential, diversification from traditional asset classes and income generation. Meanwhile, the focus on responsible investment, especially climate change and the desire to have a positive impact, has boosted interest in these asset classes.

While climate change remains an important issue for investors, many have begun to broaden their responsible investment scope. There's a growing desire to address the 'S', or 'social', element of ESG, which had suffered from a perceived lack of suitable investment opportunities.

What is social infrastructure?
Social infrastructure can be described as real estate that's integral to the functioning of society, supporting the quality of life and wellbeing of communities. An investment usually involves purchasing, and potentially renovating or developing, real estate that's then let to service providers to operate from. These can be broken down into a number of main categories:

Education – the provision of facilities for primary, secondary and further education, as well as universities. It also includes nurseries and special educational needs facilities.

Health – this involves facilities for medical, elderly and specialist care.

Civic – such as sports and community centres.

Housing – a wide spectrum including affordable and social housing, supported living and homelessness, extra care facilities, key worker housing and student accommodation.

Justice and emergency – police and fire stations as well as court houses.

Below we've provided a high-level example of a nursery investment. It begins with a community's shortage of nursery spaces, setting out the societal and economic impact, how invested capital can help address this challenge, and the positive impacts achieved alongside the financial returns.

Positive impact

One key benefit of investing in social infrastructure is the ability to use capital in a way that has a positive impact on society. 'Social impact' can be defined as a significant, positive change that addresses a pressing social challenge.

Significant social issues affecting the UK include physical and mental health (and access to care and preventative measures), the supply of suitable housing, homelessness, and access to affordable education in areas such as nurseries, as well as the overcrowding of schools. Providing capital that adds to the stock of affordable housing, doctors' surgeries, schools and nurseries will help to address these.

An important consideration when it comes to having a positive impact is whether that investment is truly 'additive'. Has the capital you've provided been used to deliver assets that address societal issues that otherwise wouldn't exist? Or have you simply taken over an already operational asset, or one that would have gained funding from elsewhere?

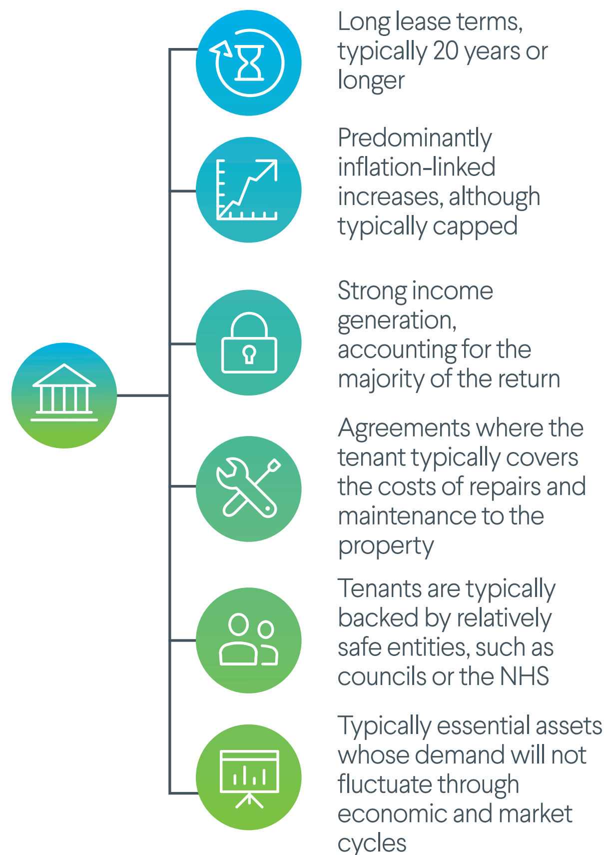
Social infrastructure as an asset class naturally lends itself to impact reporting. A fund manager will know how many houses, doctors' surgeries or nurseries the fund owns, as well as the number of people that are supported by these assets' services. However, there's always the potential for 'impact washing', where the true level of assets' impact is exaggerated. Sometimes more traditional assets, such as for the transmission of broadband, fall into social infrastructure funds based on the importance of the services they provide. But the genuine impact and additionality of these assets is less clear.

What levels of return can you expect?

The typical challenge with investments that deliver positive impact is whether that impact is coming at a cost, ie are investors giving up returns to achieve it?

We don't believe this need be the case within social infrastructure. Generally, social infrastructure benefits from severely limited supply relative to societal demands. Research by investment managers AlphaReal put the shortfall across health, education and housing at £50 billion, suggesting a strong investment case.

Returns are driven by a number of attractive characteristics:



Returns depend on the level of risk your investments are targeting. Lower risk, or 'core', investments typically target a return of 6–7% pa. Higher risk, 'value add' investments, which take on development risk in building or renovating assets, usually target returns of 10% pa or more. These are broadly in line with core and value-add property investment returns.

What are the risks?

When it comes to socially sensitive investments, risks go beyond financial losses and can lead to reputational problems if issues arise with the asset's operation. We therefore separate the risks into two main categories:

Financial

Income risk – when assets are let out, there's a risk that the tenant doesn't pay their rent. However, many tenants will be backed by councils or the NHS and so are relatively secure.

Inflation risk – rents agreed with tenants typically have floors and caps of 0% and 5%, respectively. Therefore, when inflation runs higher than the cap, the rental growth results in a negative real return. However, it also protects from deflationary environments and prevents the risk that excessive inflationary increases put tenants out of business.

Property value risk – the ownership of the properties and/or land exposes the investor to the risk that these values fall, are stagnant or only rise slowly.

Development risk – when assets are being built or renovated, risks include cost overruns and delays.

Regulatory risk – given the highly sensitive nature of these assets, governments and regulatory bodies can take a keen interest in them. Regulations may change in a way that negatively impacts returns, such as lower rent-increase caps.

Illiquidity – this is an illiquid asset class, meaning capital is locked up for a number of years and the eventual exit from any investments may be difficult.

Reputational/negative impact

When an investor's capital is being used to provide services such as education, healthcare and housing, with the potential for positive impact comes the risk of those assets being mismanaged and the investor being held responsible. It's crucial for any investor to ensure they're comfortable with these risks.

The vast majority of investors in this asset class will invest through a fund that is the legal owner of the assets. The fund manager is then responsible for the selection of the operators of these assets. Therefore, operator selection is an incredibly important component.

Is there an opportunity now?

The key reason for any market opportunity is the need for non-government funding. As government spending continues to fall short of requirements, an opportunity opens for investors to fill that gap. Unison has forecast that there will be a £5.3 billion gap in local authority funding by 2024/25, severely limiting spending capacity to meet these social needs.

As funding has reduced, demand has also increased. This is an outcome of changing demographics and social issues. The ONS has forecast that the UK's population will grow to 70 million people within 15 years, which places a large strain on social services. Exacerbating this, the ONS also predicts that by 2030, for every 100 people that are economically productive, there will be 60 who are economically dependent. There's also a growing challenge of obsolescence of existing assets – in 2019, a British Medical Association survey found half of GPs stated that their facilities were inadequate.

Through this combination of factors, a strong and long-term investment opportunity may exist, where it will also be possible to have a positive impact by addressing truly important social challenges.

Key considerations when investing

For many, an investment in a specific social infrastructure fund would be a first. Here we provide a list of important considerations to help investors avoid some of the most common pitfalls.

Manager selection

Within this asset class, manager selection is extremely important. For a fund to be successful, an investment manager must be skilled not only in asset selection, but also at selecting operators who are both creditworthy and experienced in providing a high level of service.

Right-risking

Risk and return investors can target a range of levels in social infrastructure. As noted earlier in this article, 'core' investments – investing in lower risk, operational assets – can be expected to generate returns of 6–7% pa. Meanwhile, value-add investments can earn returns in excess of 10% pa by taking on development risk.

The difference in risk types also affects how those returns are paid to investors. Core assets pay a large share of their returns as income to investors. This provides certainty to the investor of cash within their bank accounts, while value-add investment returns have a larger share driven by increases in the value of the properties owned, either through building new assets or renovating already existing properties. While this offers greater potential for returns, it will only be realised once those assets are sold.

It is, therefore, extremely important that investors focus on the areas of the market that best meet their specific needs. Those who would benefit from cash income, don't need as high a return or have a lower risk appetite should focus on core investments. However, those without income requirements and in need of higher returns should consider value-add investments if their risk appetite allows.

Positive impact and additive assets

There are two key reasons to invest in this asset class: the financial returns and the ability to have a positive impact. Investors should ensure that the assets are truly having a positive impact, and that the impact their capital is creating is additive and wouldn't have existed if they hadn't invested it. As noted earlier, impact-washing must also be avoided. Thorough research of managers and funds is essential.

Conclusion

As investors broaden their scope for impact beyond climate change, social impacts (along with needing to meet their fiduciary duties) will be high up their agendas. Social infrastructure offers an investment opportunity to achieve strong financial returns while addressing some of the UK's most significant societal issues. Manager selection, making sure you're taking a suitable level of risk and avoiding impact washing are key to the success of any investment in this area.

If you have any questions, or if you would like to discuss further, please get in touch.

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General Risk warning

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, property whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.

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