# THE CONTINUING CASE FOR INVESTING IN SOCIAL INFRASTRUCTURE

March 2022

NEWCORE
CAPITAL MANAGEMENT

Certified
B
Corporation

# About Newcore Capital

Newcore Capital Management is an independently-owned, real estate investment manager, with £300m of assets under management (AUM).

Newcore specifically targets social infrastructure assets within the UK, which are essential to society's physical needs, benefitting from limited supply, growing demand and offering resilience to technology-driven change.

Property Awards 2021 WINNER
Property Fund Manager of the Year

Certified B Corporation


**Key Information**

**£300m**

Total AUM

**64**

Total number of assets

**17% p.a.**

IRR on AUM since inception

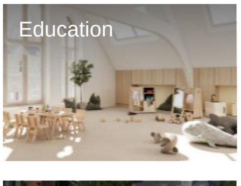
**2011**

Newcore Capital Management LLP founded

*As at March 2022*

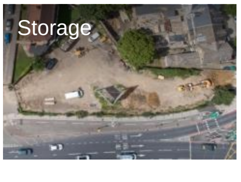
### Social infrastructure sectors

Social infrastructure real estate can be broadly defined as any physical asset essential for our society to function.

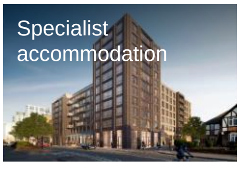













# Newcore's UK social infrastructure strategy

## Why is this compelling in the current market environment?

**Hugo Llewelyn**
**CEO**
**Newcore Capital Management**

**Background – the key issues of rising inflation and consequent contracting consumer demand**

Investors considering where to deploy their capital in the current UK market are increasingly focusing on issues around inflation. The principal concern is that, if sustained, inflation could eat into the real value of their investments, reducing future purchasing power. The knock-on effect on society could be to cause a retrenchment in consumer expenditure (less money in the pocket), damaging the robustness of consumer-facing businesses (both real and tech-based) and any investment linked to them. Those looking further afield in Europe are also concerned about the geopolitical risks arising from the Russian invasion of Ukraine. Russia's tightening of fossil fuel supply also imports inflation into the UK, given heating, transport and other energy uses all factor in the RPI and CPI calculations. A similar future fall-out with China, should they invade Taiwan, would exacerbate this.

The purpose of this note, therefore, is to set out the arguments for why UK social infrastructure real estate, run by specialists, such as Newcore Capital, may be a compelling investment for professional investors seeking assets that should outperform inflation over the next decade and continue to perform strongly, when consumer expenditure on non-essential goods and services reduces.

Our own position is that it makes sense to assume that higher levels of inflation will be here for the medium term, when we take into account:

- the increasing cost required to achieve a long-term, global, sustainable, planetary environment;
- the potential (if somewhat counter-intuitive) effect of global withdrawal of quantitative easing, reducing demand for government bonds and therefore increasing the base required return of risk capital; and
- the increasingly scarce commodities of food and natural resources in proportion to global population levels.

Advances in technology and innovation should offset these to some extent but will probably come at the point the issues are most critical. If the medium-term inflation hypothesis proves correct, then money earning little or no interest in bank accounts will quickly reduce in real value and should be invested into assets with inflationary protection and sensible, risk-adjusted returns. This could include some real estate sectors.

While we start from the basis that investors wish to invest in the UK, we highlight some of the attractions of the UK real estate market at a macro level.

**UK investment market characteristics, including real estate, compared to other markets**

The UK, alongside the US, is the pre-eminent and most professional investment marketplace in the world. It is possible to deploy in many asset classes at scale directly or indirectly, publicly or privately and to do so with strong confidence, assuming you are properly advised in the legal process and have governance and financing structures in place. The UK has a deep body of case law and common law and a robust judiciary to adjudicate legal issues around corporates, investment and finance. It also has a well-founded insurance and banking market and a favourable tax environment.

This is as true for real estate investment as it is for other investment markets. Additionally, the real estate sector is serviced by a well-regulated property consultancy and investment management market, providing products and services to investors and owner occupiers invested in the sector. Real estate in the UK is, consequently, more liquid than other markets (noting that it is still an illiquid asset class, usually taking about 1-3 months to trade at direct level, although less in some cases in indirect products).

# UK investment market expected returns

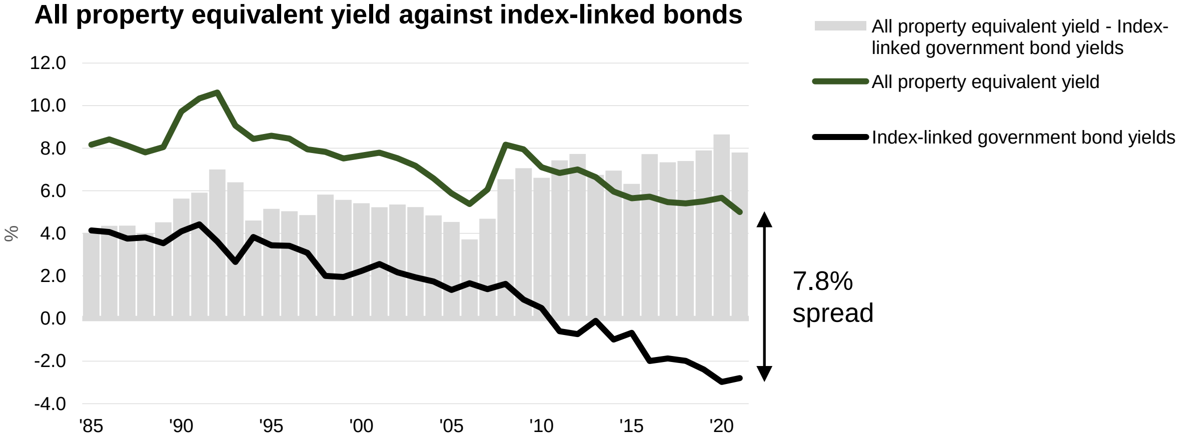
## Real estate in context with other asset classes and inflation

UK real estate ranges from old, core sectors such as offices and retail, through to new, core sectors such as social infrastructure, tenanted residential (the private rented sector) and logistics, which have benefited from fast-changing trends in UK society. Real estate can be characterised as follows, in Newcore's view, compared to bonds and equities, although at a micro level every asset is heterogenous, so distinctions apply.

| Asset class | Liquid | Inflation hedge | Typical target unlevered return |
|---|---|---|---|
| New, core real estate | No | Yes | Inflation plus 3% |
| Old, core real estate | No | No | Inflation plus 3% |
| Listed equities | Yes | Yes | Inflation plus 5% |
| Private equity (core-plus) | No | Yes | Inflation plus 7% |
| Government 10-year nominal bonds | Yes | No | 1.5% plus inflation |
| Index-linked bonds | Yes | Yes | 0.5% plus inflation |

Source: Newcore Capital

The current yield gap between real estate and index-linked bonds is at a 35-year plus high, as the graph below shows, meaning that, if one can select UK real estate with inflation-linked characteristics, it should perform strongly compared to inflation-linked bonds, against which most other liquid asset classes are benchmarked.




Source: Pantheon Economics

Consequently, investing in real estate that pays an annual income and increases in value in line with inflation looks a sound strategy at the current time. Real estate initial yields, net of property operational costs, for prime, rack-rented assets are currently at the levels in the table below:

| Sector | Prime yields | Likely to match inflation |
|---|---|---|
| Residential | 2.5% | May do |
| Logistics | 3.0% | Yes |
| West End of London offices | 3.5% | May do |
| Regional offices | 4.5% | No |
| Retail parks | 5.0% | No |
| Shopping centres | 5.0% | No |
| Social infrastructure | 5.0% | Yes |
| High street retail | 7.0% | No |

Source: Newcore Capital

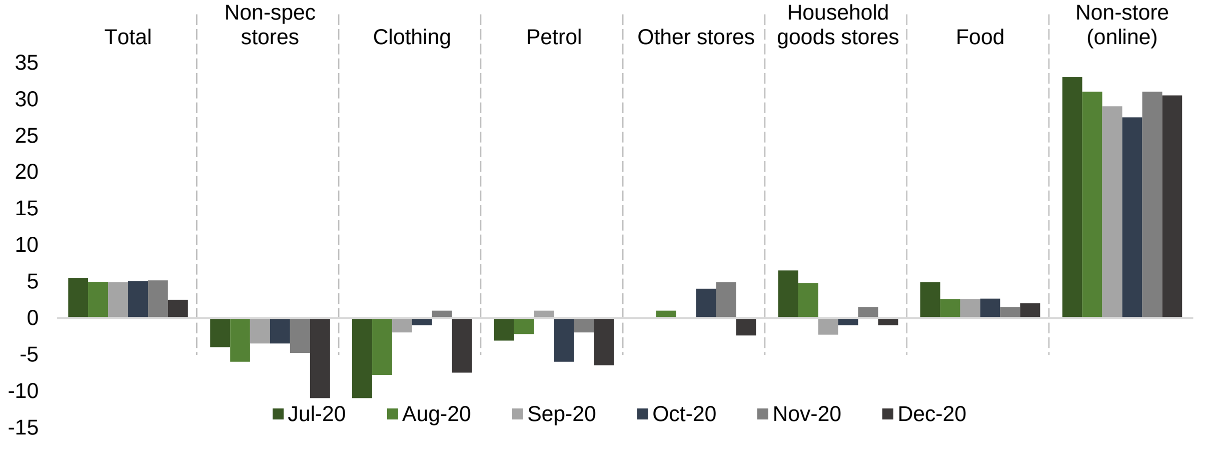
Logistics and social infrastructure property rental growth is likely to outperform inflation in the medium term, driven by consumer and demographic demand, although logistics may not deliver a sufficient risk-adjusted return from its very low initial yield base, when taking into account future obsolescence if held for the long term. Naturally, any individual asset may outperform inflation in any sector if purchased and managed well, but this note is looking at wider trends across sub-sectors of the UK real estate market.

# UK real estate expected returns

## The dynamics of yields, occupational demand and inflation

In the case of logistics, the significant change to online retailing, exaggerated further by the Covid lockdown, is shown below. Rents have increased significantly and prime yields have moved from 5% to 3% (and trending lower), as investors anticipate continuing significant rental growth to offset low initial yields. There is some concern that pricing has become unsustainable in this sector (industrial delivered 36% year-on-year returns in 2021, according to MSCI). Furthermore, it might be appropriate to redefine logistics as motorway retail (as opposed to high street retail), and the likely reduction in expenditure by consumers, given inflationary pressures, could well have a negative knock-on effect on tenant covenant strength and rental growth in the sector.

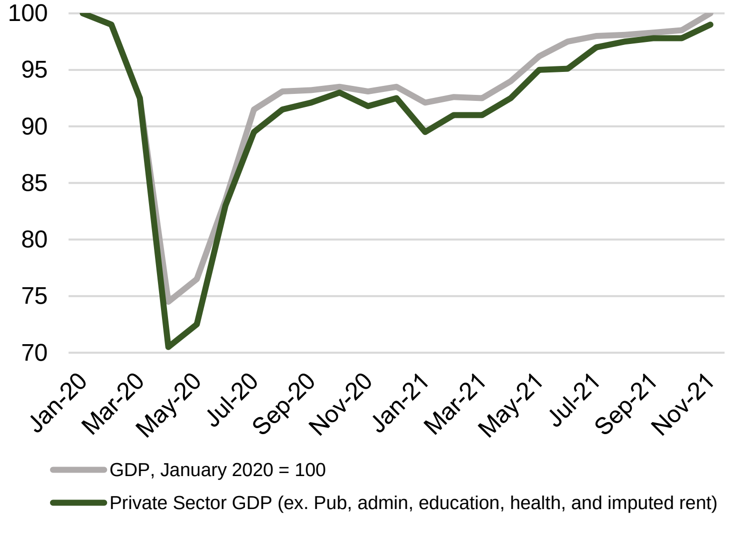
**Retail sales volumes, % above / below February 2020 level**




Source: Pantheon Economics

Social infrastructure-related uses have outperformed inflation over the Brexit and Covid hiatuses, as the growing UK population and its government have apportioned increasing amounts of their income to their essential needs, including healthcare, education, social care and specialist housing. The graph below shows how GDP in social infrastructure-linked sectors has outperformed UK GDP through the Covid lockdown period, and this is likely to continue, assisted by the fact that most social infrastructure investments have inflation-linked rent contracts at stabilisation.

**Private Sector GDP Vs GDP**




Source: Pantheon Economics


**Bristol life sciences**

*NSS Fund V purchased a medical school building, which is home to Avon Longitudinal study of Parents and Children. The site's uses benefit from public funding into both education and healthcare.*

# Not all real estate will match inflation in the future

## “Virtual estate” has disintermediated some old core sectors

There are some real estate sectors, however, that may, from a 2022 valuation base, not deliver inflation-protecting returns. Many old, core sectors have already lost nominal principal over the last decade, as well - a trend which is set to continue. Examples of these are where virtual tools, such as Amazon and Zoom, can replace the function of the real estate in sub-sectors such as secondary shopping centres, high street shops and offices in areas of plentiful land supply, but also where expenditure relating to the real estate is discretionary rather than essential (leisure and restaurants). Some sub-sectors of old, core real estate, such as West End of London offices and residential, may exceed inflation over the medium term, given supply side shortages, but they are also subject to significant obsolescence and very low initial yields. The chart above referencing online sales growth also catalogues the demise of retailing on the high street.

**Why social infrastructure looks compelling compared to other real estate asset classes**

Social infrastructure, in comparison to other sectors, should exceed inflation in rental value terms, assuming current market level rents. Additionally, yields in social infrastructure are currently higher than most mainstream old, core sectors, and leases are typically upwards-only and inflation-linked on long-dated terms. Combined with the fact that the sector has not seen the yield compression of logistics, so that it should deliver a significant element of its required total return from income, this makes a strong case for social infrastructure investment in 2022 and beyond.

Furthermore, the social infrastructure sector has not been subject to significant jumps in underlying rental value (London logistics rents, for example, have doubled in the last five years), from which yields and pricing are calculated. This means that rents are still affordable in most cases. In most assets owned by Newcore, the tenants have also invested significantly in their fit out, meaning that, if they did fail, another operator would willingly step in, given the fit-out and low rents payable (commensurate with tenant improvement). Newcore calculates that the rents being paid in the childcare sector in its London portfolio are at approximately 60% of open-market value. This dynamic also means that such buildings can be converted at sustainable economic levels to other uses, should the use be in less demand or functionality change in the longer term.

**The ESG overlay – adding to the credentials of investments that improve social infrastructure**

As investors become increasingly concerned about issues relating to environmental, social and governance areas, real estate comes under scrutiny too, given its users emit 40% of the UK’s carbon dioxide. Managers have recently started to measure and improve their environmental performance substantially in response to this and to consider the environmental cost of building new stock rather than refurbishing existing. However, they find it more difficult to deliver social impact, which goes hand in hand with the environmental aspect.

Improving existing social infrastructure assets and creating long-term sustainable assets for both investors and tenants, by, for example, adding new childcare places or healthcare beds by the conversion of vacant buildings while improving their environmental performance through better energy use, is a clear and credible strategy for delivering positive environmental and social impact.


**Central London childcare**
*NSS Fund IV purchased a vacant former adult day centre in Brixton and worked with a leading operator to convert the site into a 150 place children’s nursery, which was then let on a 25 year, inflation-linked lease.*

# Conclusion on value-add social infrastructure

## A compelling investment strategy

Investing in value-add social infrastructure assets, therefore, looks compelling in the context of UK real estate investment and, indeed, of the wider pool of assets, for investors seeking attractive real returns, protecting against inflation, and positive social impact.

Such strategies are likely therefore:

- to see strong risk-adjusted returns with a sustainable income component, inflation-linked rent increases and positive capital value increases over and above the inflationary increases in rent (positive yield shift), if market conditions remain consistent; and
- to provide a positive measurable social and environmental impact, if delivered by experts who can source the raw materials – buildings suitable for repurposing at economic and environmentally sensible cost – and turn them into future-proofed, long-term investment product at sustainable rental levels for tenants

This approach describes Newcore's value-add strategy accurately and, indeed, Newcore's current fund being marketed is an Article 9 fund under the EU SFDR. In addition, Newcore is a B Corporation, run and managed onshore in the UK, with the highest standards of ethics in business and governance, as measured externally by the B Lab organisation. If you are interested in discussing the strategy with us further please do contact the author.

**Greater London waste management**

*NSS Fund IV purchased an open storage and waste management site in Chertsey, Virginia Water. The Fund's strategy is to promote the site to higher value uses, in doing so, increasing the provision of clinical waste management. Planning has been submitted for a new waste to energy facility on the site, which is estimated to generate enough low carbon energy for 1,100 typical homes.*

*CGI of consented 62-bed care home scheme at Newcore's NSS Fund IV asset in Winchester (now sold)*

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