Newcore Capital

Investing in UK plc: a third way

Certified B Corporation

Central and local government deficits

Like all economies, the UK needs better infrastructure in order to function more efficiently. It also needs more infrastructure in order to provide more people with essential services.

Currently, HM Prison Service has delivered an extreme example – no spare capacity and poor quality facilities plus an increased need have added up to create a current crisis. We need more affordable housing, healthcare facilities, Special Educational Needs (SEN) schools, nurseries, energy generation and waste disposal facilities, mortuaries, EV charging points and plenty else.

All of this needs capital expenditure. Because government borrowing is at an all-time high since 1962, the new Labour government has already blown a loud whistle about its inability to balance the budget, announcing cuts to the winter fuel allowance and signalling tax rises in the October budget. Of course, cuts and tax rises are the two levers that governments can use to maintain services without issuing more debt.

The infrastructure challenge affects local government just as it affects central government. While the UK government can avoid becoming insolvent, local authorities can issue a s.114 notice, which means that no new expenditure is permitted, with the exception of the funding of statutory services, including safeguarding vulnerable people, while existing commitments and contracts continue to be honoured. This last resort measure has been used in the last 3 years by Croydon, Birmingham, Northumberland and Woking councils.

Encouraging private investment

There is a third way, and that is to encourage private investment in what can be called social infrastructure. In the 1990s, this was achieved through the Private Finance Initiative (PFI). This involved private companies, usually construction-based, taking on the upfront capital cost of a social asset such as a hospital in return for a long (20-30 year) build and maintain contract. This suffered from two big problems. First, whereas the government has the benefit of minimum costs of borrowing, these private companies do not, so the costs of procuring the asset was higher than if government had retained that responsibility. Second, the scheme created a huge misalignment of interest, as the assets reverted to public ownership at the end of the contract, so there was no motivation to maximise the value of the assets by appropriate property management, and there was no incentive to limit the costs of maintenance because these were fully reimbursed by the tenant

...the last thing that Labour should do is ever go near PFI again. It was a mistake, it was stupid, it was all about balance sheet engineering to pretend that debt was not rising, and actually costs were going through the roof as a consequence[1].

The Mutual Investment Model (MIM), designed by the Welsh Government to finance major capital projects due to a scarcity of capital funding, will see private partners build and maintain public assets. In return, the Welsh Government will pay a fee to the private partner, which will cover the cost of construction, maintenance and financing the project. At the end of the contract the asset will be transferred into public ownership. So this looks a lot like PFI.

There is a simpler way to encourage private investment in what can be called social infrastructure. There is both investor appetite to provide up-front capital in return for a flow of market-based rents and (hopefully) capital appreciation by resale to the private market and a group of qualified and motivated investment managers ready to raise and manage that money.

> "The last thing that Labour should do is ever go near PFI again."

In 2022 Jeremy Hunt, the previous Chancellor, announced the Mansion House Compact which committed UK pension funds to invest in venture capital focussed on UK innovation. A similar initiative is needed for social infrastructure investment.

In 2021, The Good Economy, The Impact Investing Institute and Pensions for Purpose launched the Place-Based Impact Investing Project to explore how to scale up institutional investment focused on the opportunities of place. The white paper focused primarily on the role that the £326 billion Local Government Pension Schemes could play. The paper generated widespread interest amongst local government pension schemes, local authorities, fund managers, asset owners, consultants and other place-based stakeholders including the UK government who referenced the paper in their Levelling-Up Strategy. It is an obvious win-win.

1. https://www.taxresearch.org.uk/Blog/2024/07/03/is-labour-planning-to-do-pfi-again/#:~:text=And%20what%20happened%20was%20that,which%20were%20hospitals%20and%20schools

Solving the housing crisis

The housing crisis in England is characterised by rising house prices, unsatisfactory living conditions and (for many) the unattainable dream of owning a home. Policymakers have recognised this crisis, and focussed on a lack of new housing supply as the primary problem. The new government has announced a policy resolution to build 1.5m affordable homes in the next five years.

This will require finance. Baum and Xiong (2019)[2] suggested, that around £19-25bn of capital is needed to build the extra homes. With moderate reforms and encouragement, UK institutional investors are the natural providers of equity capital, although it has to be noted that almost all of their appetite would be for rental housing, both privately rented and social/affordable. (This can include shared ownership, a potentially affordable route to full home ownership). It is possible to envisage the necessary capital being made available, making the large assumption that UK investors will continue their expansion into the residential markets from negligible levels in 1990, and around 10% today, to the global norm of around 20% or the US figure of 25%.

There is a general lack of understanding about financial markets, and in particular the relevance of index-linked gilts and liability matching to the value of inflation-indexed cash flows secured against social housing (and other social infrastructure asset types). Growing government demands on how the registered providers (managers) of affordable housing maintain and invest in their properties, including building safety, damp, mould and condensation, and decarbonisation, has forced a squeeze on operating surpluses. Nevertheless, it is arguable that the real and nominal discount rate applied to social housing should be lower than would be applied any commercial property investment.

There are a few examples of the benign social contract envisaged by the Place-Based Impact Investing Project. In April 2019, Legal and General (L&G) and (the soon-to-be-insolvent) Croydon Council announced a new partnership designed to provide affordable housing. The partnership deal enabled L&G to buy 167 homes (mainly two and three bedroom flats and houses) from the local authority for £44.6 million and then lease them back to the council over a 40-year term. The homes are managed by Croydon Affordable Housing, a local housing charity set up by the council. Part of the rental income of the affordable homes was transferred to L&G after Croydon took a slice to cover management and maintenance costs.

If Croydon took £5,000 per unit for maintenance, this would leave L&G with £1.565m a year, a yield of 3.51% and (at 2% inflation) a real IRR of 1.77%. The expected real IRR on UK government long-dated index-linked gilts in 2019 was around minus 2 per cent. L&G appears likely to have earned a risk premium over the indexed government bond of 3-4 per cent for a low-risk asset, and this seems like a win-win deal for Croydon and L&G.

2. Baum, A and Xiong, Q. (2019): Finance for Housing in England: money and the market, investment, affordability and tenure , Said Business School, University of Oxford (65pp)

Why social infrastructure?

Similar calculations can be applied to healthcare facilities, SEN schools, nurseries, energy generation and waste disposal facilities, mortuaries, EV charging points and other social infrastructure sectors, much of which is let on long leases linked to inflation, albeit often leased without government backing to private companies such as SEN school groups.

> "It is an obvious win-win if local government pension schemes commit to investments in local social infrastructure"

As an example, over the course of two years Newcore Capital acquired 30 vacant or short leased properties that were suitable for childcare provision, repurposed these through refurbishment and leased them to a series of high-quality childcare operators, typically on long leases (15-25 years). The operators usually co-invest in the buildings by paying for part of the fit-out, reducing the rent charged to more affordable rents. This protects the operator's EBITDA and reduces the risk of the investment to Newcore and its investors. The rents are indexed to inflation, producing highly attractive cash flows to investors looking for low risk real returns. The portfolio (now around £55m in value) returns an initial income of around 5.75%, rising with inflation, and has delivered unlevered double digit returns including capital growth generated by the refurbishment and leasing process of buildings that might otherwise have been demolished. Childcare has an important role to play in allowing both parents to work and improving productivity for young professional families, and this investment has contributed 2,395 childcare places for Greater London.

Institutional investment in real estate used to focus on the retail and office sectors (83% in 2001; 50% and falling today - see Table 1). Much of the slack will hopefully be taken up by affordable residential investment, but there is lots of spare capacity for funding other social infrastructure asset types like childcare that central and (especially) local governments are under pressure to provide.

Institutional allocations to real estate sectors

	1991	2002	2023
Retail	**37%**	**45%**	**20%**
Office	**47%**	**38%**	**22%**
Industrial	**13%**	**13%**	**32%**
Residential*	**0%**	**1%**	**12%**
Other*	**2%**	**2%**	**15%**

Source: MSCI
*Includes social infrastructure sectors

It is an obvious win-win if local government pension schemes commit to investments in local social infrastructure delivering low risk inflation-proof income streams, while at the same time improving the scale and quality of much-needed local services that the sponsoring local authority is struggling to provide.

What sort of manager?

It has been widely reported that Sir Keir Starmer and Rachel Reeves recently held a number of discussions with senior figures from US/North American private equity firms, emphasising the importance of private markets in growing the economy and funding the green transition. Some of the managers they are said to have met are the biggest real estate investment managers on the planet, so this is a positive and understandable development. **However, when it comes to funding social infrastructure, including affordable housing, care needs to be taken regarding the motivation and track record of the investment manager**.

“The UK real estate and social infrastructure space includes several such B Corporations”

According to a paper by Ludovic Phalippou of the University of Oxford Said Business School[3] Private Equity (PE) funds (usually US-based) have returned about the same as public equity indices since at least 2006. Yet the estimated total performance fee (carry) collected by these PE funds is estimated to be $230 billion, most of which goes to a relatively small number of individuals. The number of PE multi-billionaires rose from 3 in 2005 to 22 in 2020.

The scandal-scented failure of Home REIT in the UK is another warning about inappropriate management, this time centred on the excessive use of leverage (debt) and inadequate expenditure on maintenance and improvement of its housing stock. These suggest over-optimistic promises about returns in the capital raising process, and fees based on gross asset values including debt. Instead, **we need impact-focussed patient capital working with impact-focussed managers**. The profit motive remains a strong motivator to achieve outstanding results, but needs to be tempered by the broader sense of purpose captured by (for example) the B Corporation (B Corp) movement, promoting for-profit corporations certified for their social impact.

B Corp certification is conferred by B Lab, a global non-profit organisation. To be granted and to maintain certification, companies must submit to regular checks regarding their social and environmental performance. The UK real estate and social infrastructure space includes several such B Corporations[5]. Exemplifying this cultural shift, the performance fee that Newcore might earn from its value-add social infrastructure funds will be subject to income tax, and not (as is common practice among private equity managers) CGT.

We need to build symbiotic relationships between providers of capital with a social purpose and managers of capital with the same social purpose without compromising the returns delivered and allowing managers to build profitable but responsible platforms. The sector is UK social infrastructure; the managers are ready; the time is now.

Andrew Baum
Emeritus Professor, University of Oxford
Chairman, Newcore Capital Management

Certified B Corporation

For the uninitiated, B Corps are businesses that promise to do good, not only for their shareholders but also for consumers, employees, local communities and the environment. They aim to make a profit, but try to be “decent” in the way they go about it.

The Times, September 2024[4]

3. Ludovic Phalippou (2020): An Inconvenient Fact: Private Equity Returns and The Billionaire Factory, University of Oxford, Said Business School
4. https://www.thetimes.com/article/faade227-3a63-4ec6-99de-11c3a42e3304?shareToken=c35440f406ab1b6ab717e9774d23ffdc
5. For example, Bridges Capital, Octopus Investments and Newcore Capital (Property Week Property Fund Manager of the Year in 2024)

Newcore Capital has delivered financial out-performance and sustainability impact through investing responsibly in assets that are essential to society's needs, for more than a decade.

Newcore focusses on UK real estate investment, and is a management-owned business, with £500m of assets under management. Newcore is a Certified B Corporation and manages capital for local government and other pension funds, insurance companies, European fund-of-fund managers and family offices.

Newcore is a specialist investor in social infrastructure real estate within the UK: assets which it believes are integral to society, benefiting from limited supply, growing demand and generally offering some resilience to technology-driven change. Social infrastructure real estate can be broadly defined as any physical asset required to allow our society to function. Newcore specifically invests in the real estate behind these sectors, leasing its assets to a range of operators. It targets existing assets that can be improved for the benefit of all stakeholders delivering both financial and social returns.

www.newcorecapital.com

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Lucy MacEwan – Lucy.MacEwan@newcorecapital.com

Newcore Capital Management LLP
First Floor
50 Marshall Street
London W1F 9BQ

Newcore Capital