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In focus

How real estate investing can have a real social impact

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Investment decisions can have more social and environmental impact now than ever before. We explore why real estate investment is uniquely placed to address major social inequality in the UK and the role which institutional investors can play, working in partnership with local government and other stakeholders.

One of the features of the UK is the big gap in prosperity between different parts of the country. Academic studies suggest that the UK has one of the highest levels of regional inequality among developed economies, even exceeding that of Italy and the US[1]. It is sometimes argued that that the UK would achieve faster growth if economic activity were spread more evenly, as in Germany, and there was a counter-weight to London such as a "Northern Powerhouse", or "Midlands Engine".

It has also been suggested that the vote to leave the EU in 2016 was in part a protest by people in slower growth areas who perceive that their (or their children's) living standards have stagnated[2]. This has resulted in the government's "levelling up" agenda.

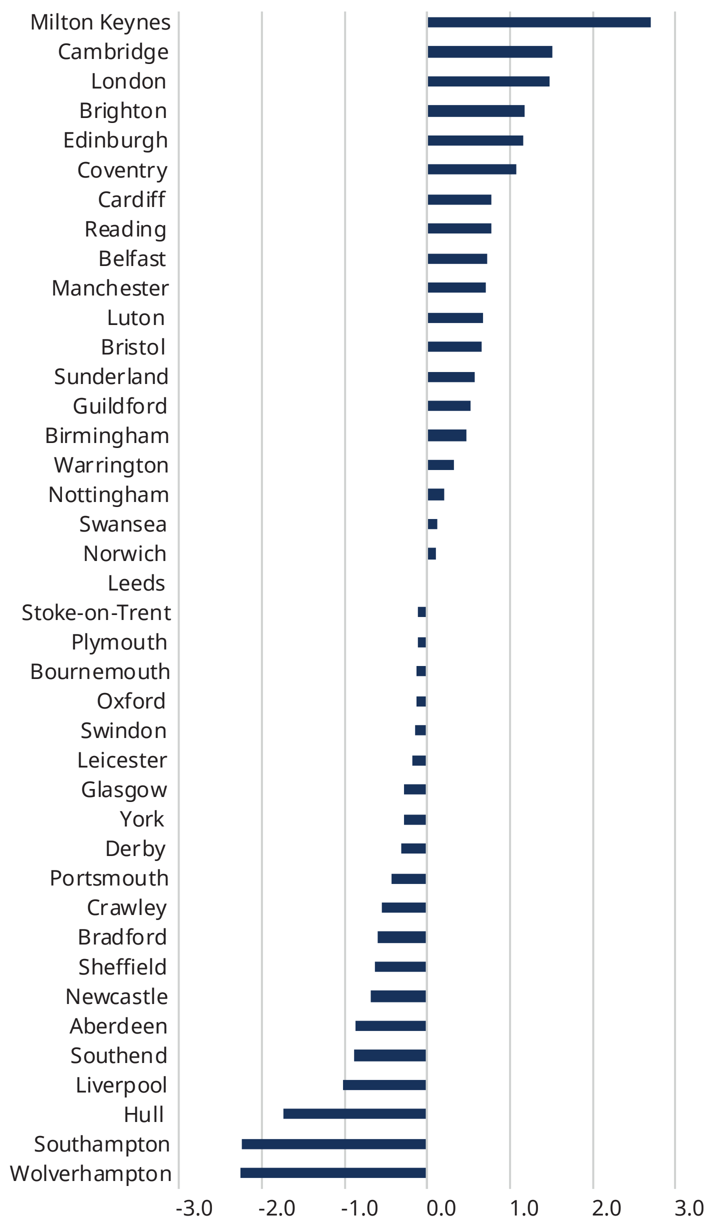
However, this is not just an economic, or political issue. It is also a social issue. Local data show that unemployment and low wages are highly correlated with poorer health, higher crime rates and inadequate housing, resulting in areas of multiple deprivation[3]. Covid-19 has only exacerbated these circumstances, disproportionately affecting people in deprived areas[4].

The good news is that many institutional investors are keen to participate in the solution and regard the social return on these investments as equally important as the financial return (so called "Impact Investing"). Given the positive impact these investments can have on both the social as well as economic outlook of an area, we strongly believe both demands can be fulfilled to the benefit of all stake holders – as well as in many cases the environment.

Figure 1 shows the variation in economic growth across 40 towns and cities between 2010 and 2020. The set includes most places with a population of over 200,000. On average the UK economy grew by 0.4% p.a. over the last decade, although the rate is depressed by the pandemic. (The UK economy grew by 1.8% p.a. between 2009-2019).

However, what is striking is the range in economic growth. A fifth of towns and cities (8 out of 40) grew by more than double the national average between 2010-2020. By contrast, five of the places towards the bottom of the ranking had seen virtually no growth between 2010-2019. That's before they were hit by the pandemic.

Figure 1: Economic Growth 2010-2020



Source. Oxford Economics, Schroders. December 2020.

Schroders

The chart reveals two broad patterns:

1. The North-South divide in economic growth

With several notable exceptions. The majority of towns and cities in London, the south-east and Eastern regions are in the top half of the ranking. The majority of towns and cities in other regions, "the North" are in the bottom half of the rankings.

Crawley and Southampton have been hit particularly hard by the pandemic, because of their economic dependence on air travel (Gatwick) and cruise ships, respectively.

2. Big cities, bigger growth

Big cities have generally seen faster economic growth than towns and smaller cities in the same region. In the north-west, Manchester has grown faster than Liverpool and Warrington and the same pattern can be seen in the south-west (Bristol vs Bournemouth, Plymouth and Swindon) and Yorkshire (Leeds vs Bradford, Hull, Sheffield and York). The exception is the West Midlands where Coventry has seen stronger growth than Birmingham.

Clustering, forward looking economies

One simple explanation for the success of Cambridge, Coventry and London is that they have attracted dynamic companies in finance, IT, media, professional services, life sciences and advanced manufacturing. In a similar vein, part of the success of Edinburgh and Milton Keynes is that they are not burdened with a legacy of old coalfields, or defunct heavy industry.

Likewise, the fact that big cities have generally seen faster economic growth than towns and smaller cities is consistent with the theory that businesses in the same industry benefit from being close to one another and once a cluster is formed more companies then join. Economists call this the benefits of agglomeration.

However, while these explanations are valid, raise a number of additional questions. Big cities may see faster growth, but how did they get big in the first place - what was the catalyst which started the virtuous circle? Why have some former industrial cities, ports and seaside resorts like Manchester, Bristol and Brighton had more success in re-inventing themselves than other places with a similar heritage like Bradford, Liverpool and Southend? Or more importantly, how can a struggling town turn itself around?

What is the recipe for a successful city?

While there is no single answer here, we think there are five main ingredients which go into making a strong local economy:

- a diversified economy
- a highly educated labour force
- well developed physical infrastructure
- good leadership
- liveability

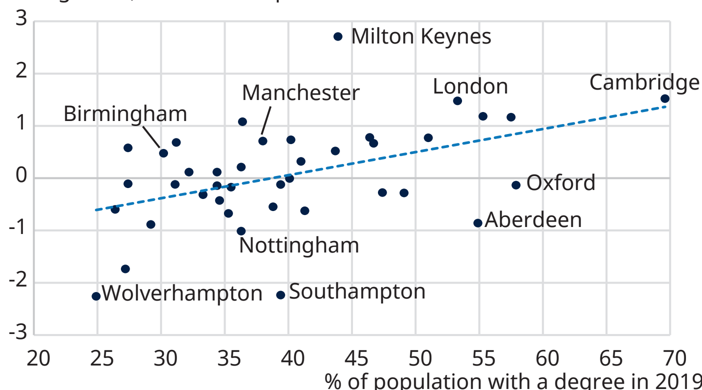
Diversified economy

A diversified economy, with a variety of different industries and size companies, generally means that a town or city will be more resilient in a downturn and less vulnerable if a major employer stops operations. Start-ups are important for the potential of innovation as well as new job generation, especially if they manage to attract new talent and expand into bigger companies. Cities which are dominated by one, or two large vertically integrated companies run the risk of atrophying in the long-term.

Highly educated

A related factor is a highly educated labour force, which in turn means good universities and schools. The long-term growth in professional and technical jobs – the so called "knowledge economy" - has raised the demand for graduates. There is a broad correlation between the ranking of the 40 towns and cities in Figure 1 and the percentage of the population with a degree.

Figure 2: Population (%) with degree vs city's economic growth



Source. Centre for Cities, Oxford Economic, NOMIS, Schroders. December 2020. Note data on qualifications are for residents rather than the local workforce, which will be different to the extent that people commute between towns.

Moreover, companies in IT, advanced manufacturing and life sciences are increasingly putting their research facilities close to leading universities and research institutes, because new products are becoming too complex to develop in-house. At the same time, universities are opening up to commercial collaboration and supporting academics to launch start-ups which will boost royalties from intellectual property.

Good physical infrastructure

Motorway junctions are a magnet for logistics companies and warehouses. New projects such as Crossrail, HS2, or the planned Transpennine rail upgrade influence where companies decide to locate and where people choose to live. However, although big transport projects are important, probably equally critical is getting traffic to flow freely within towns and cities, by improving local bus services through re-regulation and encouraging more people to cycle, or walk.

Climate change means that other types of infrastructure including flood defences, the electricity grid and water supplies are becoming increasingly important. For example, the risk of a water shortage is highest in London and the South-East, but it is also potentially a problem in Birmingham, Nottingham and perhaps surprisingly, Manchester, despite its reputation for rainfall. Fixing leaking pipes will help, but it will not solve the problem. Other measures will be necessary, including building more reservoirs, creating a national network to pump water from regions with plentiful water supplies[5], and adapting buildings to harvest rainwater for flushing toilets and watering gardens.

Leadership

Good schools, universities, transport and physical infrastructure do not just happen. They have to be planned and managed. A fourth important factor for a successful local economy is good leadership and public and private cooperation. In part this is about local government. Thus, Manchester's revival from the 1990s onwards was helped by a proactive council led by Sir Howard Bernstein[6]. The devolution of certain areas of public spending to

elected mayors and combined authorities in England should boost the long-term economic growth of places that have signed deals[7]. The people who use local services are better placed than civil servants in Whitehall to make decisions on skills training, health campaigns, bus timetables, new roads or cycle paths, etc.

But local leadership is not just about local government. It is also about the connections between local councillors, non profit organisations and business people, academics and financiers. A study of smaller post-industrial cities in the "rust belt" of the north east and mid-west of the US[8] offers some explanation for how they successfully re-invented themselves. In a nutshell, local business people got fully involved in regeneration plans and did not regard it as the sole responsibility of the city council and "not my problem". Arguably, one of the obstacles which delayed Liverpool's economic revival was the mistrust which existed between the city council and local businesses through the 1980s and the first half of the 1990s[9].

Liveability

Finally, it clearly helps if a city is an attractive place to live with a mix of old and new buildings and a range of cultural attractions including sports venues, museums, theatres, restaurants as well as offering different sorts of living opportunities. While towns like Milton Keynes and Reading lack the charm of Brighton, or Cambridge, they have a wide array of leisure facilities.

While all these individual factors are important, it is critical that they are seen in combination in a wider regeneration plan, as none of these factors by themselves are a guarantee of economic and social success. For example, it is not inevitable that a good university will spawn an IT, or life science cluster, if most students leave as soon as they graduate (e.g. Durham, Loughborough). Likewise, although better transport links should benefit a town, they could also allow companies to leave and serve the town from further afield. The evidence on high speed trains in France and Spain is ambiguous and suggests that Paris and Madrid may have benefited more than regional cities[10]. Improved accessibility is a two way street.

Inequality Within Towns and Cities

In addition to variations in prosperity across different settlements, there are also big variations within towns and cities. Although data for England show that Hull, Liverpool and Middlesbrough had the highest number of deprived neighbourhoods relative to their size in 2019[3], deprived areas are not confined to slower growing local economies. London and Manchester have a large number of deprived areas, mainly in the east of both cities and Brighton, Coventry, Milton Keynes and Reading also have pockets of extreme deprivation. It is an inconvenient truth that some of the fastest growing cities in the UK are also among the most unequal.

The shortage of social housing means that many people on low incomes have no choice but to live in private rented accommodation, taking a disproportionate part of their disposable income away from other areas of expenditure (e,g, food, clothing). While housing benefit or universal credit meets some of the extra cost of private rented housing, they are subject to caps. The squeeze on disposable incomes is greater in faster growing cities, where there is strong competition for rented accommodation from young professionals.

Figure 3 lists the 20 local authorities with the highest rates of child poverty, defined as the percent of children living in families with a disposable income - after housing costs - which is less than 60% of the national median. As might be expected, some of the highest rates of child poverty are in places with relatively weak economies such as Middlesbrough, Oldham and West Bromwich.

Figure 3: 20 Local authorities with highest child poverty rates in 2018/19

Local authority	% of children living in poverty
Tower Hamlets	55.4%
Newham	50.3%
Barking and Dagenham	49.9%
Hackney	48.0%
Waltham Forest	47.4%
Southwark	44.3%
Islington	43.4%
Greenwich	43.2%
Lambeth	43.0%
Haringey	42.4%
Lewisham	42.0%
Birmingham	41.6%
Redbridge (Ilford)	41.3%
Middlesbrough	41.1%
Brent (Wembley)	40.8%
Hounslow	40.8%
Manchester	40.6%
Sandwell (West Bromwich)	40.4%
Oldham	39.9%
Luton	39.8%
UK Average	**30%**

Source. Local indicators of child poverty after housing costs. Donald Hirsch, Juliet Stone, Centre for Policy Research, Loughborough University and the End Child Poverty Coalition. 2020.

However, the shortage of housing in London means that child poverty is also a major problem in the capital. 40-50% of children in inner London live in poverty, even though many of their parents are in work.

The data above are for 2018/19, before Covid-19. Unfortunately, there is a significant risk that child poverty has increased over the last 12 months, because the pandemic has disproportionately affected families on lower incomes and especially those on flexible, or zero hour contracts.

People on lower incomes are more likely to live in over-crowded housing, to have jobs where they cannot work from home (e.g. construction, public transport), or have zero-hour contracts in retail and hospitality which have been badly disrupted and not subject to furloughing arrangements. The acute shortage of housing in Birmingham, Edinburgh, London, Manchester and other cities also raises the question of whether they can continue to function and prosper, if people on lower incomes can no longer afford to live there?

The role of real estate investors

Traditionally, investors have shied away from deprived areas and focused on real estate in big city centres and affluent towns. Demand for space (as distinct from need) is typically stronger and there is an established investment market of buyers and sellers providing liquidity.

However, while most investors will continue to concentrate on maximising financial returns, Schroders believe there has been a fundamental shift, possibly accelerated by Covid-19, towards strategies which generate a positive social and environmental impact. The perceived conflict between fiduciary duty and sustainable investment reflects a historical view that social benefits and investment returns are drawn from the same, finite pot.

If that was ever true, the equation has definitely changed as social concerns and tensions have moved up social and political agendas. The value of companies or assets is increasingly tied to the social benefit they provide. Pension funds and asset managers' fiduciary duties increasingly require them to incorporate sustainability and positive social impact into investment strategies as a result.

More importantly, as shown by our analysis above, we believe that investment with social impact will actually drive additional positive economic outcomes and thus enhance financial returns over the long run.

The same can be said for investments which positively contribute to the environment, e.g. by reducing CO2 output, use of scarce resource and waste output. A combination of social awareness and wider fiduciary responsibilities towards a broader set of stakeholders, as well as further governmental policies and regulations will steer the investment market towards more sustainable assets. Governments are raising energy efficiency standards and starting to ban equipment which generates carbon emissions (e.g. gas boilers). Occupiers increasingly favour buildings which are sustainable and promote health and wellbeing (e.g. high quality air conditioning, cycle stores). Real estate which has positive social and environmental features is less likely to suffer from obsolescence and is more likely to retain its value over time.

So where should investors focus their attention?

Homes

Given the importance of the living environment above, we believe a clear priority should be given to building new housing, particularly affordable and social housing for people on low incomes. At present, housing associations rely on a mix of government grants, bank borrowing, bond issues and profits from building homes–for-sale to fund new social and affordable housing. Yet there is also a limit to how much debt housing associations can take on and still retain a triple A credit rating. Housing associations had average gearing of 51% in 2019[12].

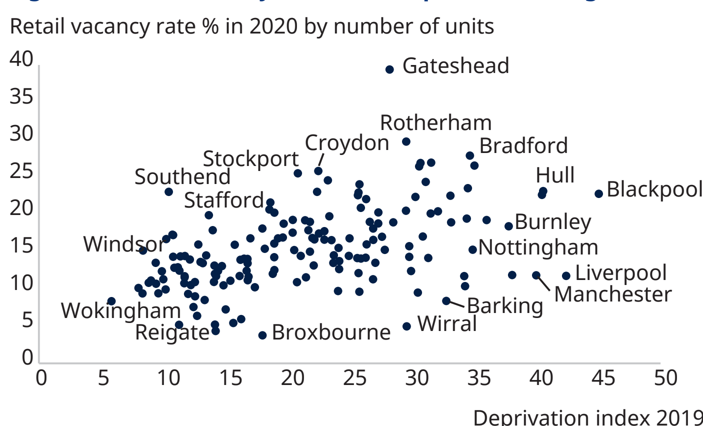
Also, the cross-subsidy from selling private homes and the partial reliance on section 106 agreements to acquire sites, means that the supply of new social and affordable housing has to some extent become tied to the private housing market. That might make it more difficult to expand the supply of social housing, if the private housing market weakens.

However, private investors have taken up the challenge and are now engaging to build new social, or affordable housing, and then lease the homes to a housing association to manage on a day-to-day basis. Schroders has already used this model to invest in social supported housing for adults with learning disabilities. In such a model, the investor can either own the whole scheme or a part thereof, with a mechanism for the housing association to increase its share over time. A variation on the same theme would be for investors to partner with local authorities and fund the construction of new homes on land which they own. The government's decision to abolish the housing revenue account borrowing cap in 2018 has removed one of the main obstacles to local authorities building more homes.

Town centres

Another major challenge facing deprived areas is town centre regeneration. While the growth in online shopping and increase in vacant shops is a national phenomenon, the problem tends to be more acute in deprived neighbourhoods. In part this is for the obvious reason that people in deprived areas have less money to spend, but it also because house prices and commercial values are often too low to make it viable for developers to convert empty retail schemes into other uses.

Figure 4: Retail Vacancy Rates and Deprivation in England



Source. Local Data Company, ONS, Schroders. Note the retail vacancy data are for 164 towns and cities at end-2020. The data on deprivation are from the English Indices of Multiple Deprivation 2019. Deprivation increases from left to right.

There is a much greater chance that a vacant department store in Guildford, or Harrogate will be re-developed into apartments, social housing, retirement housing, etc., than a similar building in Clacton, or Wolverhampton. The government has announced a number of policies to help regenerate town centres in less affluent areas (e.g. Future High Streets Fund, Levelling Up Fund, Shared Prosperity Fund), but they will not succeed without private investment.

Workplaces

Real Estate investors can also help communities in deprived areas in other ways. Employment is one method. An increase in jobs through the private sector provision of office, retail and industrial space at a zero, or discounted rent to local start-up businesses, charities and other non-profit groups would provide a new form of local income.

Investors should think through different economic models that would allow housing or commercial schemes to incorporate new public spaces, or gardens as part of the programmes. Given there is a strong link between people's physical and mental health, these additional provisions should not be seen as a free grant, but as a means to deliver long term sustainable growth for the environment and income for assets. The key starting point for all these initiatives, whether it is new housing, commercial space, or a GP surgery, is to take a "hospitality mind set", to find out in the broadest possible context what services the local population and stakeholders require and to think flexibly about how these services should be delivered and which economic models and solutions can be applied.

Balancing financial and social returns

As mentioned throughout this article, we believe that investing with impact does not mean a lower financial return and in fact, could ultimately drive more sustainable financial outcomes in the longer run. As a simple example, the payback period on installing LED lighting is typically between 1-3 years. However, in other instances such as charging lower rents to local start-ups, or using land to build social housing rather than homes for sale, there is a clear opportunity cost. In these circumstances the size of the trade-off will vary from project to project and so too will the mix between income and capital growth and the timing of returns.

Social and affordable housing are seen as lower risk as they tend to deliver stable financial returns, mainly composed of income. Regeneration projects can take a decade, or longer to come to fruition and initially, may involve a lot of risk and little, or no income, but if successful, can deliver strong capital returns. The regeneration of Kings Cross in London has been a great success, but Argent, who developed the scheme, attended over 300 public meetings and invested £100 million in infrastructure before receiving any income.

In conclusion, increased public / private collaboration is required to tackle the problems of inequality. Real estate investors have a big role to play. Many institutional investors are keen to participate in the solution and will value the social return from these investments as being equally important as the financial return. Given the positive impact these investments can have on local communities and economies, we strongly believe both interests can be fulfilled to the benefit of all stake holders – as well as in many cases the environment. We believe it is possible to build a UK real estate portfolio which will deliver a positive real return, both in a financial sense and in terms of making a practical contribution to society and the environment.

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