XPS Investment

Charity Briefing
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Does property provide an investment opportunity for charities and not-for-profits?

Over the last few years property has faced many headwinds, from Brexit to the gilts crisis. This has led to investors looking elsewhere for the diversification benefits and income that property has traditionally provided. In this paper, Joe Howley, considers whether there is an opportunity for charities and not-for-profits to look again at the investment case for property.

Key highlights

- An investment in property can generate returns through both income yield and capital growth. As well as providing protection against inflation and offering diversification benefits.
- Charities in particular are uniquely positioned to benefit from an investment in property due to the Stamp Duty Land Tax exemption.
- Environmental and social considerations are implicit within investment in property, with scope to pursue non-financial objectives along-side earning a financial return.
- With such a wide range of property investment available, we believe that investors can benefit from bespoke advice to find the property mandate that is the right fit for them.

Property market overview

We have recently witnessed significant headwinds for property investors. Macroeconomic concerns that have affected property include the downturn in the UK economy and the sharp rise in interest rates. These factors led to particularly poor performance in the second half of 2022. Since then, the market hasn't quite recovered. Valuations have been more stable but the volume of commercial property transactions taking place remains low indicating that confidence has not returned to the property sector yet.

There have also been other sector specific headwinds over the last few years. Notably, COVID and the rise of home working caused a significant increase in the spare capacity in offices across the world, albeit, this has subsided recently. The retail sector has also struggled as the inexorable rise of ecommerce has left many traditional high street retailers facing bankruptcy. Nowhere has this been felt more than the department stores which have traditionally been a cornerstone of British high streets.

> The bricks and mortar of property does still provide opportunities for investors. Land in prime locations will always be sought after and properties have the advantage that they can be repurposed.

Joe Howley – Head of Property Research

The flip side of the rise in ecommerce is that logistics has been one of the most in demand sectors for property and had consistently performed well up to the summer of 2022. However, the low yields available on logistics at that time meant that it was one of the sectors hit hardest by the sharp rise in yields over the second half of 2022. The fundamentals behind the popularity of logistics do remain strong.

Logistics makes up the 'sheds' part of the so called 'sheds and beds' that have proved popular with investors in recent years. With so called 'beds' such as residential properties, hotels and student housing also showing more resilience to the macroeconomic headwinds that property has faced.

Despite these headwinds, the bricks and mortar of property does still provide opportunities for investors. Land in prime locations will always be sought after and properties have the advantage that they can be repurposed (in fact, some investors specialise in doing just that). Leases also have in-built inflation protection – either explicitly or implicitly, which ensures that real income can be protected in a way that other lower risk assets, such as debt, cannot. With valuations still compressed following the 2022 gilts crisis there has been an increase in press coverage recently on the opportunity for long term investors to purchase property assets on the secondary market and benefit from the market turbulence we have seen over the last few years. We also recognise the additional benefits for charity and not-for-profit clients, as we explore more in this paper.

These definitions, and range of examples, clearly reflects the recent High Court judgement on trustee investment duties (Butler-Sloss vs Charity Commission 2022) which confirmed that trustees can exclude certain investments based on non-financial considerations such as ethical or environmental factors as long as they are satisfied that their approach is in line with the charity's purposes and values.

Use of property by charities and not-for-profits

Property was often the first port of call for investors looking to diversify their holdings away from a traditional equity and bond mix. It has however become less fashionable in the investment world with other diversifiers, such as hedge funds and infrastructure, gaining a greater share of investor's asset allocation.

Asset class overview

It is worth considering the characteristics of property as an asset class. Property can:

- generate returns through both income yields (in the form of rental payments) and capital growth (when the underlying asset rises in value);
- provide protection against inflation through rental increases and value appreciation;
- offer diversification against traditional equity and bond portfolios; and
- offer a number of different implementation routes with a range of liquidity options to suit an investor's needs.

Most investors already have a good understanding of the asset class and, whilst the assets are illiquid in their nature compared to listed assets, this can also provide a return pickup due to an illiquidity premium.

In addition, for UK charities there is also a material tax advantage over other investors as they are exempt from stamp duty land tax (SDLT). This can lead to increased returns for those investors if they invest via a fund where all investors are registered as charities.

Charities typically have a long time horizon and relatively clear sight of cashflows so they are well placed to take advantage of the less liquid opportunities in property investment.

> With such a wide range of property investment available, we believe that investors can benefit from bespoke advice to find the property mandate that is the right fit for them.

Alasdair Gill – Head of Charities & Endowments

What factors should investors consider when investing in property?

Investment vehicle

Property investment is very broad and there are a vast array of options available to institutional investors.

Investors should consider the type of fund or vehicle to use when investing in property. Broadly speaking, the main two methods for investing are either in a co-mingled / pooled fund or segregated portfolios / separately managed accounts.

For investors who are looking to invest via a fund, there are two different approaches to consider. Either an open-ended fund where shares in the fund can be traded periodically, i.e. monthly or quarterly, or closed-ended funds which have an initial fundraising period and investors capital is returned to them once the fund has completed the investment period.

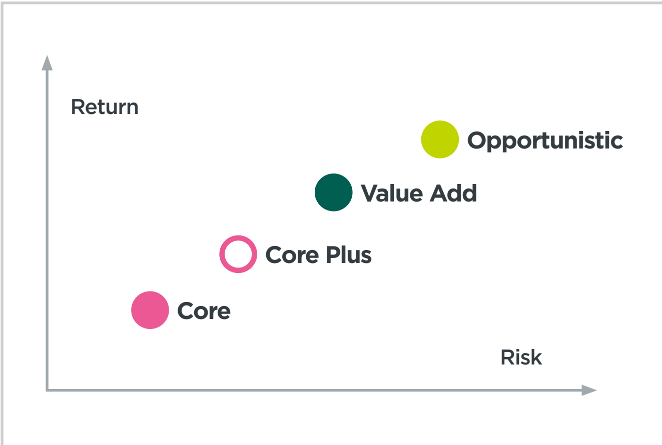
Open-ended funds are generally more liquid than closed-ended funds and do not suffer from the 'J curve' effect like closed-ended funds do. However, closed-ended funds provide managers with more certainty on timescale and hence the freedom to earn excess returns as all the capital can be invested without having to provide liquidity to investors.

Relative to pooled funds, segregated mandates or separately managed accounts offer investors the opportunity to work with the asset manager to develop investment guidelines that are specific to their requirements and as a result, the manager can build a bespoke portfolio tailored to the investor's needs. Typically, this approach involves more complexity and cost but for some investors this a tailored approach can lead to a portfolio more suitable for their needs.

Risk exposure and investment strategy

Investors also need to consider the level of risk that they wish to take. There are four broad categories: Core, Core plus, Value add and Opportunistic.

Core property mandates are the lowest on the risk spectrum and tend to have no or little development risk. Risk, and potential returns, increase as you move up the risk spectrum to Core Plus, Value Add or Opportunistic assets. As you move up the risk spectrum, development costs tend to increase and managers tend to use Closed-ended investments to access the riskier areas of the property market.



Importance of investment advice

With such a wide range of property investment available, we believe that investors can benefit from bespoke advice to find the property mandate that is the right fit for them.

In line with the latest from the Charity Commission, if an investment manager is appointed, the Trustee board should consider taking objective advice independently of the investment manager in respect of the performance achieved, the level of risks taken, and the costs incurred with the investment. When appointing a manager for investing in property it is vital to understand how that investment suits an investor's objectives, constraints and level of governance available before investing in an illiquid asset class such as property. Particularly given a decision to invest cannot typically be unwound as easily as an investment in more liquid assets such as equities and bonds.

ESG in action for investors

Many charities consider Environment, Social and Governance (ESG) to be a key element of their investment strategy and property investment offers an opportunity for Charities to put ESG considerations into action.

The new investment guidance for Trustees 'CC14'[1] provides a key distinction between 'financial investment' and 'social investment' rather than the sometimes-vague terms that were previously used. Property has always been a financial investment and remains suitable for that category. However, we have also seen emerging strategies in property that could fit under the 'social investment' category for charity investors. Strategies that focus on providing affordable or social housing where it is required can provide significant social benefits and could well further many charities' purposes (for example, welfare or housing charities) rather than solely being a financial investment.

Property investment also provides an opportunity to ensure that a charity's asset strategy is in line with its environmental objectives or purpose. Environmental concerns are essential in the development and management of property. There has been a significant shift in the last few years as managers engage with tenants more and more on environmental matters, often incentivising tenants through 'green leases'.

Green Leases explained

A green lease is a lease arrangement which promotes good environmental practice by incentivising the tenants to undertake environmentally friendly policies. Typically, this could involve waste management, improving energy efficiency or reducing water usage.

Well managed property funds also need to ensure that their governance is sufficient to meet the ongoing regulations that property managers must meet. Recently, we have seen more stringent regulations come into effect on EPC (energy performance certificate) ratings and biodiversity. All newly rented commercial properties must have an EPC rating of at least C from 2025 and major building projects are now legally required to deliver at least a 10% increase in biodiversity when work is undertaken. For charities, ensuring that they are compliant with regulations is important for their reputation.

[1] https://www.gov.uk/government/publications/charities-and-investment-matters-a-guide-for-trustees-cc14

Summary

We see property as an attractive long-term asset for charities and endowments to invest in. Property can provide a significant income yield, protection from inflation and offers potentially strong returns for charities due to their tax-exempt status. Investors with a long-term perspective and good oversight of their liquidity requirements can accommodate some illiquidity within their portfolio which can otherwise be a barrier for investors.

In line with the latest guidance to charity trustees, property can offer trustees more than just the financial returns, with some property funds and managers specialising in providing social or environmental benefits as well as financial returns. There is scope for a wide range of strategies to provide societal benefits and there are opportunities for relevant charities who want to further their purpose through their investment portfolio.

How can we help?

There are a wide range of property funds out there and our knowledge of the market can help charities assess whether property is right for them and find the fund that best meets their objectives – both financial and social.

For more information, please get in touch with Joe Howley or Alasdair Gill or speak to your usual XPS Investment contact.

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