ESG Viewpoint

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A Focus on Affordable Housing

- Housing is a basic human need, and the provision of housing as a social mission has been established for hundreds of years.
- The growing inequality between rich and poor, and the existence of chronic housing shortages in hotspot areas, make the provision of affordable housing a critical imperative to achieve the Sustainable Development Goals.
- Institutional investors are now stepping into this area, which can provide appealing financial characteristics alongside positive environmental and social impact.
- Partnerships with existing housing providers, and credible impact measurement and monitoring, are important steps to avoid 'greenwash' and to maximise the positive attributes of investments made.

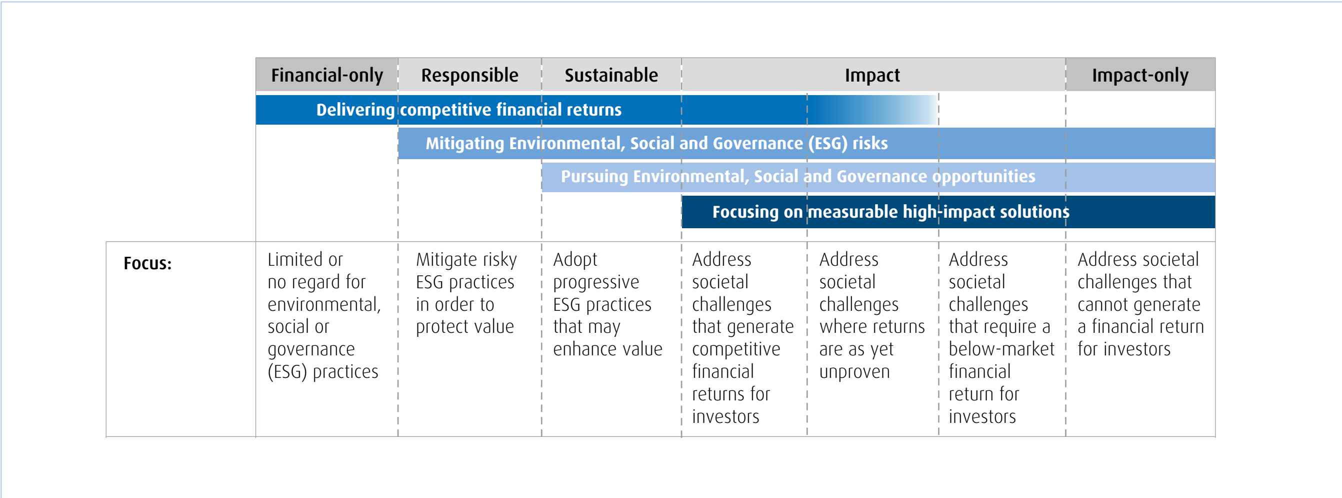
The growth of impact investing

The emerging consensus that capitalism should be less short term and more inclusive to the wider society is quickly establishing itself in mainstream investing. For years considered niche, the growth of sustainable and impact funds is facilitating genuine change in many areas of society and the environment.

The concept of "double bottom-line" investing considers not only the financial return provided, but also the positive impact that invested capital has been able to create. Impact funds range greatly across providers and asset classes. They are generally distinguished as being investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return.

> A home should be an anchor against being swept into poverty.
>
> **Joseph Rowntree Foundation**

Spectrum of Capital



Source: Bridges Fund Management, as at 2017

Historically, impact investing fund structures were often more akin to private equity funds. Whilst having strong impact credentials, these often struggled with liquidity, resulting in a high proportion of investors shying away from the investment opportunity.

With the impact fund sector now in excess of US$500bn according to the Global Impact Investing Network and a significant proportion of investors comfortable with the concept, double-digit growth is expected to continue.

Impact investing in real estate

Is there the same appetite for sustainable real estate investing as seen in other investment categories? The growth in membership of GRESB, the ESG benchmark for real estate, is one indication that sustainability is a mainstream consideration in this asset class – GRESB members now represent over US$22 trillion AUM, with fund coverage now exceeding 1,000 property companies. It's fair to say that true impact-driven real estate investing is a newer concept than the consideration of sustainability within mainstream real estate, but the core fundamentals to drive demand and supply are all in place.

From an investment point of view, with low interest rates the real estate sector has been viewed as a way to diversify investment risk for life and pension fund portfolios. Long-term rental housing can act as a strong diversifier as it is less correlated to other more cyclical property asset classes. The various leasing models associated with affordable housing also offer inflation linking. The credit strength of the sector and inelastic demand, particularly through the global financial crisis, has helped reinforce the view of the sector as a credible source of diversification.

For investors who are seeking positive sustainability solutions alongside financial returns, real estate investment can have both important social and environmental benefits. On the social side, housing represents a key tool for cities looking to develop to cope with growing, transient and ageing populations that require employment and social infrastructure – housing, healthcare, education. And environmentally, the development and operation of housing presents the opportunity to drive long-term environmental change through forward-looking design that creates operationally efficient homes, reducing carbon footprints and enabling social benefits such as reduced fuel poverty. Credible impact investment in real estate demands that investors consider both these aspects.

Finally, the myth that for high-quality impact to be achieved, financial returns must either be a secondary factor or an additional consideration, have been shown to be false. Certainly, in terms of real estate, the provision of well governed, affordable housing solutions offers clear social benefits, along with the benefits that new housing stock offers in terms of operational efficiency for the owner and occupier, reducing costs and returning income back to the investor.

Why focus on affordable housing?

A lack of affordable housing is a global issue and not one exclusively seen in developing markets, with acute issues also common in property hotspots in Western Europe and North America. Whilst there is no single definition of affordable housing, generally the term captures a wide spectrum of housing options, varying from social rent, to intermediate rent, to first-time buyer schemes aimed at getting people on the property ladder.

Affordable housing looks to support low to middle income

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households, such as vulnerable groups requiring housing subsidy, or key worker households that are ineligible for social housing, yet struggling to find an affordable solution in the mainstream private rental market.

The potential demand for this type of housing is huge. In the UK, the combination of a history of selling public housing to private owners, together with high population density, has led to chronic housing shortages, with affordable housing a key crunch point. There is a current estimated housing deficit of 380,000 new homes per year, with one study estimating that 133,500 of these should be either within social housing or intermediate rent schemes[1]. A second report found that around 25% of UK households are living in poverty and 56% of those households are in full time work[2]. Rent is generally the highest individual cost to tenants each month.

Affordable housing benefits not just those who live in these homes but also the community as a whole. A shortfall of affordable housing has a direct impact on the ability of employers to recruit. Key workers, for instance, are essential to a city's prosperity – with the COVID-19 crisis a very present reminder of the importance of these workers for the functioning of society. However, this is a group that can quickly be priced out of all but the least desirable areas.

Why is institutional investment in affordable housing important?

In the UK market, legislative and tax changes have made private 'buy-to-let' schemes less attractive, leading to a professionalisation of the private rental market, with institutional investors stepping in to fill the gap.

This has some important advantages over the traditional UK model of individual private landlords, for both the tenants and for society:

- Having larger, commercial property management companies overseeing rental properties can offer a higher, more standardised level of service for tenants.
- Commercial property management companies are often able to offer longer tenancies, in contrast with private landlords where tenancies may be shorter, creating a lack of certainty for tenants. Longer tenancies allow individuals to integrate into the wider community and contribute more freely, with the knowledge that the area is their home and not just a stopgap building in which to reside.
- Efficiencies for the landlord will be reflected in the occupational costs to the tenants, meaning their rental payments are more affordable – which often leads to higher occupation rates, underpinning financial returns.
- Where new build is possible, there is an opportunity to design, build and operate new homes that will almost certainly have a better environmental profile than the majority of older housing stock. This not only improves the carbon intensity of the property stock, but can also support the development of modern construction technologies, stimulating new industry and the associated employment opportunities.

These benefits do not come automatically with the shift from private to institutional money – the right partnerships and management structures have to be in place to ensure that benefits to tenants, communities and the environment are realised.

Working in partnership

A further advantage that institutional investors have in entering this space is the existence of housing associations that can, if considered a good fit, partner with one or more institutions to assist in the allocation of capital and management of properties. There are several in the UK alone with long track records of successfully delivering affordable housing schemes. These organisations often have deep relationships with local authorities that can be leveraged in the development and sourcing stages.

For the investor, having the ability to partner with an association that offers a strong cultural fit is a huge benefit to achieving impact efficiently. These organisations are generally well governed and transparent. It is essential that strong governance structures are put in place to oversee the partnership and fund's assets.

For the Housing Association, the partnership provides off balance sheet capital, enabling them to continue their social mission with less reliance on cross subsidy or grant funding models.

Measuring impact

Being transparent, understanding the impact achieved by investment and being able to consistently measure it are core factors to ensure investors and wider stakeholders understand investments in this area. Accusations of 'greenwashing' can be extremely detrimental to the reputation of a fund and to the wider sector. It is therefore essential that thorough impact assessments are conducted and shared with investors. Impact in real estate cannot be reduced to a single metric. There are different aspects of impact which need to be recognised and measured, and any potential housing investment may be market-leading in some areas but only reaching minimum standards in others. For BMO's UK Housing strategy, we use a scorecard to give us a rounded view, and act as a guide to assessing investment suitability – see Box.

[1] https://www.crisis.org.uk/media/239700/crisis_housing_supply_requirements_across_great_britain_2018.pdf
[2] https://www.jrf.org.uk/report/uk-poverty-2019-20

BMO UK Housing strategy
Approach to impact measurement

Every potential investment for our UK housing strategy is given a rating of 1-3 stars on six key impact areas:

1. **Affordability and Provision**: How well does the development meet the expectations of the local authority, and how affordable is it in the local market context?
2. **Societal Change**: Does the development support local community development?
3. **Quality of property management and governance**: Does the management of the scheme support social objectives?
4. **Environmental Impact – Consumption/ Production**: Will the development be environmentally sustainable and efficient?
5. **Environmental Impact – Surroundings**: Is the development mindful of local ecology and biodiversity?
6. **Resilience**: Is the development resilient to future shocks, such as those resulting from climate change, as well as changing economic or political circumstances?

Our internal guidance provides detail on what is expected at the one, two and three-star levels for each of these criteria, with one star representing our minimum requirements, and three stars indicating exceptional additionality. For instance, on the fourth criteria, a one-star development would exceed mandatory minimum standards on key environmental metrics; a three-star development would be net zero carbon.

We expect all our investments in this strategy to have at least a one-star rating on all metrics, and a weighted average of at least 1.5 stars (with greater weight given to those metrics we see as the most important). As well as the initial assessment, the metrics are monitored on an annual basis.

Affordable housing is also an important contributor to the achievement of the United Nations Sustainable Development Goals (SDGs). Adopted by all United Nations Member States in 2015, the SDGs provide a shared blueprint for peace and prosperity for people and the planet, now and into the future.

Two of the 17 goals link directly to the provision of affordable housing:

Each SDG has a set of underlying targets, with SDG 11.1 particularly relevant to the affordable housing agenda: "By 2030, ensure access for all to adequate, safe and affordable housing and basic services and upgrade slums".

The benefits of new housing stock in terms of energy efficiency also have a strong link to SDG 7 – Affordable and Clean Energy, and SDG 13 – Climate Action.

The energy efficiency benefits of new housing stock, link to goals:

The governance of impact measurement also matters in providing integrity. For BMO's UK Housing strategy, we have a separate majority independent impact advisory committee that is responsible for advising the investment manager on the structure and application of the impact framework. This brings an opportunity to access experts in the field through a formal structure.

> Social and affordable housing is one of the key sectors where investors can make a difference to reach multiple Sustainable Development Goals, including the fight against poverty (SDG 1), and sustainable cities and communities (SDG 11).
>
> **Sébastien Garnier, Managing Director, AxHA**

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Conclusion

We at BMO Global Asset Management are optimistic about the future, and we believe in the ability of society, companies and individuals to come up with sustainable products and solutions to respond to these challenges and create opportunity from adversity.

There has already been progression within responsible investment from values to valuation, as investors came to realise that the ESG issues previously seen as purely ethical could be financially material. These are then integrated into the mainstream investment processes.

We believe a further shift is now taking place towards impact, as the financial sector takes greater responsibility for the consequences of its decisions on the wider economy and society. We believe this a positive trajectory for our industry and we will continue to strive for leadership within this area.

Ultimately, the delivery of more affordable housing can impact those from the most vulnerable to the economically active households that are ineligible for social rent, but unable to buy. Acceleration and evolvement of housing delivery to provide for these households represents systemic change and real impact for the individuals and the community in which they live.

BMO REP and the BMO UK Housing Strategy

BMO REP are BMO Global Asset Management's direct real estate specialists and a key part of our Alternatives offering, managing over £6bn of assets across the UK and Europe through diversified and specialist strategies.

BMO REP's focus is to create and manage successful property investment portfolios for our clients and properties that work for our occupiers. Our approach is underpinned by our commitments to:

1. Be the real estate firm that makes things better creating sustainable and productive properties
2. Embrace the challenges of the changing environment and promote long-term investment horizons
3. Respect the stewardship we have of the built environment

The systematic and explicit inclusion of ESG factors into investment analysis and investment decision making is a core principle under which we operate. The tangible nature of real estate assets, with their exposure to physical aspects and significance to policymakers, amplifies the importance of the ESG dimension.

The evaluation of positive impact criteria provides a deeper means by which to consider these ESG factors. We look to create positive environmental, economic and societal outcomes, as well as contribute to solutions in underserved markets where government is increasingly seeking private finance to deliver. Recognising this in the UK housing market and within the context of urbanisation trends, we have launched the BMO UK Housing Fund (the Fund) and within this have identified a number of impact themes aimed at promoting systemic change to the provision, affordability, construction, management and operation of residential units within the private rented sector in the UK.

The Fund intends to address a distinct space in the UK housing market, targeting low to middle income households, often cited as the squeezed middle, who can find themselves failed by the existing UK housing market, ineligible for social housing and unable to buy. The Fund has developed a product that it believes will be attractive to longer-term institutional investors, predicated on strong ESG and Impact policies which are underpinned by robust and credible governance structures that guarantee delivery of homes that will satisfy occupiers' needs today and in to the future, whilst also prioritising environmental considerations and promoting sustainable living, with the aim of creating thriving communities for the long term.

The Fund provides a credible vehicle through which investors can deploy their capital in a purposeful and impactful way, supporting the drive towards systemic changes in the operation and management of the private rented sector in the UK.

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Key risks

Past performance is not a guide to future performance.

The value of your investments and any income from them can go down as well as up and you may not get back the original amount invested.

The value of directly-held property reflects the opinion of valuers and is reviewed periodically. These assets can also be illiquid and significant or persistent redemptions may require the manager to sell properties at a lower market value adversely affecting the value of your investment.

How BMO Global Asset Management can help you

BMO Global Asset Management incorporates material ESG issues into its investment processes across asset classes. We also offer our Responsible Funds range, which invests in companies operating sustainably and excludes those not meeting our ethical and ESG criteria, and our ***reo***® engagement service, through which we provide engagement and voting services covering global equities and credit.

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