Social Infrastructure: A dual return asset class

Social infrastructure projects, such as hospitals, schools and community centres, may be attractive assets for institutional investors seeking to make both a market rate of return and an impact return, which is the measurable improvement on environmental and community related aspects. However, this dual return focus requires managing the social and environmental impact of an investment while also managing for market-rate financial returns.

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Since the 2008 financial crisis and its aftermath, governments across Europe have been struggling to meet the growing demand for the building blocks of strong communities – affordable housing, schools and libraries, and hospitals and nursing homes. Government cutbacks opened an investment gap in social infrastructure estimated at €150 billion a year, according to the EIB. Institutional investors are stepping into the breach.

Between 2009 and 2016, private investment in social infrastructure grew to €247 billion, according to Preqin data. Of the 1,264 deals completed globally, 71 per cent were in Europe – the top region for this growing asset class.

These assets are particularly attractive to long-term investors because they can offer a dual return: a market rate financial return that typically comes from long-term inflation-linked lease contracts, and an impact return, which is the measurable improvement in the quality of life of communities resulting from investments that upgrade a school or a hospital, for example, or increase the supply of social housing.

The dual return nature of social Infrastructure derives from some of its unique features:

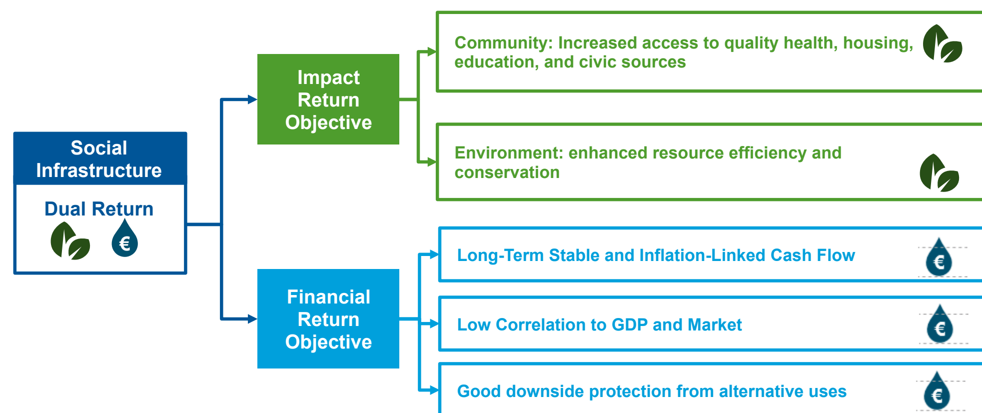
- **Stable long-term cash generation:** Social infrastructure investments generally provide stable cash generation, with revenue arising from long-term inflation-linked lease contracts.
- **Low volatility:** Social infrastructure investments are typically less vulnerable to volatility, as they are linked to necessities.
- **Low correlation:** Social Infrastructure generally shows low correlation to traditional asset classes such as equities and fixed income.
- **Asset size:** Generally, social infrastructure assets are much smaller than other infrastructure assets and real estate assets, allowing greater diversification.
- **Yield:** Social infrastructure assets provide a yield that is typically lower than infrastructure, as they are significantly more liquid. Yields are typically higher than real estate despite being expected to provide better risk adjusted return given their lower correlation to GDP.
- **Community impact:** Social infrastructure assetsprovide essential services to the community and improve access to basic facilities/amenities that in turn will improve living standards.
- **Environmental Impact:** Active asset management allows for improving and maintaining of the environmental performance of Social Infrastructure assets.

The measurement and reporting of financial performance is well-defined in the investment management industry, but how best to measure and report on impact is less clear and requires utilizing a combination of impact management standards and bespoke solutions.

The growth of impact investing

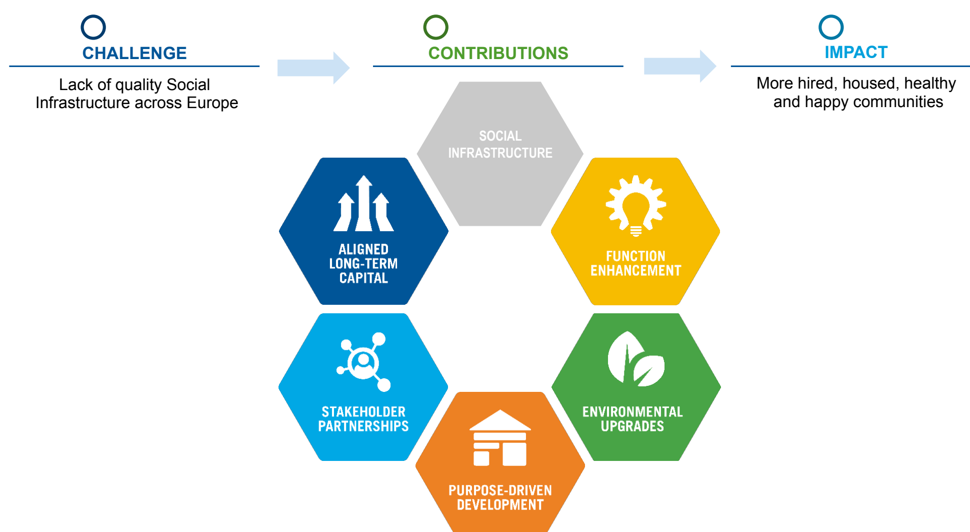
Let's start by defining impact investing. **The defining feature of impact investing is the explicit intention to generate positive, measurable social and environmental outcomes alongside a financial return[1].** Impact investing differs from other kinds of

Exhibit 1: Social Infrastructure as a dual return asset class.



Source: Franklin Templeton. For illustrative and discussion purposes only.

Exhibit 2: Theory of Change in Social Infrastructure.



Source: Franklin Templeton. For illustrative and discussion purposes only.

sustainable and responsible investing strategies, such as the exclusion of certain investments on ethical or religious grounds, or thematic investing, which focuses on specific societal problems such as water scarcity or the fight against climate change.

Impact investing is gaining attention and money across Europe. The Global Impact Investing Network (GIIN), a non-profit organisation that focuses on the promotion of impact investing, tracks the activities of the world's leading impact investing organisations. Its 2018 survey identified housing and infrastructure as one of the major sectors of focus for impact investors, together with energy, microfinance and others. Nearly two-thirds of impact investors reported that they target risk-adjusted, market-rate returns[2], which further strengthens the case for social infrastructure as a natural fit for impact investing.

Managing impact in Social Infrastructure-

Impact investing is a relatively new field, and like many frontier disciplines, it suffers from varying expectations of investors, a fragmentation of approaches and a lack of standardisation for measuring and managing the social and environmental outcomes of investments.

Efforts are under way to define potential and actual impacts. There are now a range of tools that enable investors to manage for social and environmental impact with increasing rigour and confidence. Organizations ranging from the International Finance Corporation (IFC) to the United Nations Development Programme have led initiatives that are helping to cement global standards and best practices. Investors may also rely on impact related metrics and third-party certifications when developing a methodology to manage impact throughout the entire investment process – from initial selection stages to the maturity of an asset and divestments.

At Franklin Templeton, our **Real Assets team proposes a three-step theory of change** for managing impact in social infrastructure investments: identifying the challenges, defining an investor's potential contribution to solutions, and finally achieving impact by managing these intended contributions throughout the life cycle of each asset.

The challenge

It is important to begin by identifying the challenges we seek to address. We group these challenges into two categories – community and environment. All the challenges we seek to address are aligned with the United Nations' Sustainable Development Goals. Franklin Real Assets Advisors' approach to social infrastructure investing contributes to six of the SDGs: good health and well-being, quality education, decent work and economic growth, sustainable cities and communities, climate action and life on land. Exhibit 3 captures some of the key social and environmental performance indicators we track in alignment with these SDGs.

The **community challenge** is clear: there is an inadequate supply of quality social infrastructure in Europe. However, there is less clarity about the value of an asset from a social/community perspective. The community value should be assessed from different dimensions, such as degree to which an asset meets a need in the community or how well the asset performs in serving its community purpose. For instance, impact is not just about the number of classrooms or housing units available. It is about students getting the most out of a university that offers high-quality facilities and building homes that are affordable and desirable.

The **environmental challenge** has many dimensions as well – global warming, water scarcity, biodiversity, to name but a few. Take climate action. By many measures, buildings use more energy than either industry or transport and account for 20 per cent of global greenhouse gas emissions, according to the World Economic Forum. Buildings also generate 30 per cent of all the waste in the EU. Our climate challenge, therefore, is to reduce the climate footprint of social infrastructure assets.

The Contribution of Investors and Managers

Once the challenges are set, investors need to define the ways in which they can make a difference. Here are five broad ways in which they can do so.

Aligned long-term capital

This refers to how investors and managers of social infrastructure assets can align long-term capital in order to be reliable stewards of the assets they hold. In some arrangements, like a buy-and-lease-back, they can free up much-needed public capital and provide liquidity to municipalities.

Function enhancements

This contribution speaks about investors' ability to create a positive social impact by directly improving the quality of the asset. For example, renovations that update social housing units or that improve the accessibility of a building for the elderly would be considered Function enhancements.

Environmental Upgrades

Building renovations can also create a positive environmental impact by reducing pollution (installing solar heating, for example), saving water, improving energy efficiency and encouraging the responsible recycling and disposal of waste.

Purpose-driven developments

Select investment opportunities may arise for purpose-driven developments, such as converting a warehouse or factory into buildings with a social purpose, or adding additional space for social services at existing assets

Stakeholder partnerships

Stakeholder engagement is the fifth, crucial, way in which social infrastructure investors and managers can make a difference. Tenant and community partnerships, for example, can help investors identify the need for co-working spaces or child-care facilities.

By ensuring that investments include one or more of these five actions, it is possible to track how investments are better serving communities and nature.

Exhibit 3: Sustainable Development Goals and KPI's of Focus.

Community	• Individuals provided new or improved access • Number and type of patient visits • Caregivers employed or trained
	• Individuals provided new or improved access • Students per classroom • Classroom space developed or enhanced
	• Community programs offered or supported • Community-level socioeconomic characteristics • Permanent employees supported
Environment	• Facilities re-use / space redeveloped • Energy efficiency improvements • Housing constructed or improved
	• Greenhouse gas emission reductions • Waste reductions • Water conservation practices
	• Land sustainably managed • Biodiversity practices enhanced • Green space developed or improved

Source: United Nations Sustainable Development Goals, and Franklin Templeton Investments. For illustrative and discussion purposes only.

Impact must be managed as well as measured

Impact management is not just a matter of looking at the end result. **Impact returns are best achieved by integrating impact management throughout the investment process: sourcing, due diligence, portfolio construction and monitoring & reporting.**

At Franklin Templeton, we do this with tools that give us continuous feedback on our impact objectives, measuring our progress in a way that allows the road-map to be corrected or reassessed as needed. We believe this is the best approach to align investment and impact considerations at every step.

It's clear that not all possible avenues of impact are economically viable. To this end, we have created an internal impact rating system that measures the current and projected state of each asset's community and environmental performance and only reflects economically viable impact contributions. This proprietary rating system is rooted in industry metrics such as IRIS impact standards. Progress can be quantified by tracking key performance metrics over time.

Social infrastructure plays a critical role in the health and vibrancy of local communities. As physical assets, they also have an impact on the health of our planet. By bringing impact-focused private capital to the social infrastructure space, the community and environmental performance of these assets can be markedly improved. But in order to achieve social infrastructure's full potential for dual returns, non-financial impacts must be managed in a way that is transparent and accountable.

FOOTNOTE

1 Adapted from the Global Impact Investment Network (GIIN)
2 Global Impact Investment Network (GIIN): Annual Impact Investor Survey, June 2018

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