London Borough of Harrow Pension Fund ('the Fund')

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Property Opportunities

Introduction

Following the EU referendum held on 23 June 2016, there has been heightened economic uncertainty and volatility across most asset classes. The purpose of this paper is to consider the impact of Brexit on the UK property market and identify tactical opportunities for the Fund within this asset class.

Impact of Brexit on UK property market

We do not believe that the UK commercial real estate market will suffer the same magnitude of capital value losses that followed the last downturn (mid-2007 to mid-2009) when values fell by 44% and net initial yields increased by 330 bps (source: MSCI IPD UK Monthly Index).

However valuations are likely to be put under pressure over the short term as the uncertainty around Brexit continues (indeed independent valuers are now caveating their valuations with a market uncertainty clause), occupier demand wanes and foreign investment is reduced. The Central London office market is likely to be hardest hit given that a fully-fledged Brexit could see some employment falls in the financial sector and lower occupational demand generally.

We also expect to see some pressure on more secondary assets in non-core locations across the UK, reflecting weaker economic conditions in the UK as a whole. We would, however, expect core commercial funds with a focus on primer assets to outperform their peers. Whilst we expect capital values to fall in the short term, the income producing nature of property means that it is still an attractive asset class for long-term investors and we would still expect positive returns over a five year period, all else being equal. In addition, we are not in a period of oversupply as was the case in 2007, a weak pound should help to cushion the fall in overseas investment into the UK and there will now be a period of continued low gilt yields. All these factors will provide some protection against significant rises in UK property yields.

Although it is early days following the referendum result, fund managers are seeing price reductions of up to 10% on individual assets compared to pre-Brexit valuations, although a 5% reduction appears to be the general result. A number of the primer core commercial funds returned around minus 2% over July. Leasing activity remains strong with managers reporting that the leases they have agreed are in most cases being signed at pre-Brexit expectations.

As a result of the referendum a number of retail funds took steps to stop

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outflows, including closing to redemptions and increasing the dilution levies. However, other than one retail fund, they are disposing of assets in a disciplined manner and not offering assets at “fire-sale” prices.

Institutional property funds in general have not experienced large outflows, although a number of funds have taken actions to protect remaining investors and to deter redemptions. This has included a small number of funds taking the unprecedented step of implementing a fair valuation adjustment where the managers (independent of the fund management team) have marked down the independent valuations. These actions led to large distortions in the benchmark return last quarter.

Property opportunities

We believe there are three key ways in which the Fund could exploit opportunities within property at the current time:

- Through core property funds which may be accessed at discounted pricing via the secondary market at the current time.
  - Secondary market pricing for a number of funds is at a level which will offset all of the usual entry spread to reflect notional purchaser's costs, including stamp duty land tax. We have seen entry costs come down from NAV plus 6% to around NAV minus 2-6% depending on the fund.
- Through managers which specialise in distressed and undermanaged properties ('value-add / opportunistic' property funds).
  - Short term pricing corrections may also create buying opportunities for higher return seeking value-add/opportunistic funds. If assets are sold at values well below their intrinsic value, value-add/opportunistic funds will undoubtedly be able to take advantage of market uncertainty (coupled with the usual investor flight to safe haven, higher quality assets).
- Real estate debt whole loan funds offer unleveraged returns in excess of core commercial property with the added attractiveness of an equity cushion of around 35% of the value of the underlying properties and a higher distribution yield. In addition, in the immediate aftermath of Brexit managers are seeing Loan to Values (LTV) falling and margins widening as traditional lenders become more risk averse. Given the fall in gilt yields, real estate debt now seems more attractive on a relative value basis compared to government and corporate bonds post Brexit.

  The focus of the discussions around property at the meeting on 7 July was predominantly around value-add and opportunistic property and therefore we have not delved into the details of real estate debt. We would be happy to provide further information should the Pension Fund Committee require this.

Opportunistic / Value add Property

Value-add and opportunistic funds target returns in excess of traditional core, diversified funds. In the context of the UK market, leveraged returns would be in the region of 10 to 15% net IRRs depending on the strategy. This compares to our current long term return assumption for UK core, diversified property of just over 5% per annum (unleveraged).

Investments would be made via a close ended fund (a limited partnership-style structure) typically for a term of around 10 years, which can usually

be extended at the manager's discretion by up to two years.

Value-add funds look to achieve their returns from investing in assets which have been under-managed and which usually require capital expenditure and/or significant lease re-positioning. This provides an opportunity to substantially improve an asset's rental cash flow and to benefit from capital value growth via cap-rate compression. Target returns will be around 10% per annum net of fees and fund level gearing will typically be 40-50%.

Opportunistic funds seek higher returns still (c. 15% p.a. net of fees) and will invest in distressed assets, more complex ownership structures (such as joint ventures), direct lending (usually with profit participation) and speculative developments amongst other strategies. Fund level gearing will typically be in the range of 50%-65%.

We believe that the uncertainty is likely to create opportunities for more value-add and opportunistic focussed funds. Managers who are able to purchase properties with strong fundamentals below fair value will be in a very good position to benefit from Brexit.

Our buy-rated managers will invest alongside other investors and participate in the upside performance (over a performance hurdle). This helps creates an alignment of interest between manager and investors.

The closed ended structure allows the manager to implement their business plans without distraction and with certainty over funding and enables them to choose the exit timing/strategy of the assets they purchase (within the bounds of the fund life and any permitted extensions.)

How to access these asset class

Given that these property opportunities are niche asset classes, we suggest that the most appropriate way for the Fund to gain exposure to this is via an agreed framework with us whereby we bring to your attention any suitable fund opportunities as and when they arise.

- As an example, for a c. £60m mandate we believe that 2-3 managers should provide the minimum appropriate level of diversification. Governance issues will need to be balanced against the need to diversify risk.
- We have one UK opportunistic property manager who is looking to launch a new fund later this year, targeting a first close by year-end. We buy rated their previous fund which followed a similar strategy.
- We are also in due diligence with a European opportunistic property manager who is currently raising capital, targeting a first close by the end of 2016 / early 2017.

Although Asia and the USA is within our opportunity set, our preferred exposure would have a UK-bias. We also think there is merit in considering Pan-European funds which focus on the UK and Northern Europe.

Value-add and opportunistic funds are undoubtedly higher up the risk curve than core property funds and there is clearly a greater risk of equity loss due to the impact of gearing. Timing is therefore critical. These investments are also highly illiquid given that the likely investment holding

structure will inevitably be closed ended.

Implementation considerations

Below we set out the implementation issues that should be considered:

- Investing in this asset class would add to the governance burden of the Pension Fund Committee. This particular area of property investment has a very specialist focus and the Committee would need further training on the subject and, of course, careful ongoing monitoring of the manager would also be required.
- Manager fees for value add and opportunistic funds would be in the order of 1 to 1.5% per annum on committed and invested capital. There will also be a performance fee of around 20% over an 8% preferred return. It is important to note that, like private equity investment, capital commitments are drawn down over time so it is unlikely that you will not be 100% invested from day one.
- As previously noted, selecting a manager for this asset class requires careful due diligence and expertise, more so than other traditional asset classes. If you opt to make an investment in this asset class, we have a highly capable team in house who can carry out the required research and bring forward the most appropriate opportunities for your approval. In order to do this, our proposed one-off fee for a £60m mandate (approximately 10% of the Fund) would be in the order of 0.10% of commitments (c. £60,000 excluding VAT).
- This approach would minimise the governance burden of the Pensions Committee as Aon Hewitt would put forward the recommended funds for investment. However, the Trustees would still be required to sign fund documentation and to authorise cash movements when drawdown notices are made. We would suggest that, once an investment opportunity has been identified and the necessary due diligence carried out by us, we put forward a section 36 letter to the Pensions Committee setting out our advice prior to investment.

Recommendation and next steps

- If the Fund wishes to increase its exposure to property, it could consider purchasing units in core funds at potentially discounted prices via the secondary market. Alternatively, the Fund could consider investing in distressed property via closed ended opportunistic funds.
- We suggest that a 10% allocation (c. £60m) to closed ended funds would offer a suitable level of exposure.
- Given the specialist nature of opportunistic and value add property funds, and to minimise the governance burden we would recommend that Aon Hewitt is given the mandate to identify suitable fund opportunities within this asset class for your approval.

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