Aon Hewitt
Retirement & Investment

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

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Property Allocation Options

Executive Summary

We believe that a key element of a UK pension scheme's property allocation should be to core commercial property; it is a well-established asset class where our clients typically invest in funds with little or no leverage and which invest in properties that are well let in strong locations and have returns driven by income over the long term plus potential for capital growth through active asset management.

Despite being Qualified rated, we would not recommend significant divestment from the Aviva Investors UK Real Estate Fund of Funds. This investment provides the Pension Fund with a good platform to expand its property allocation into alternative property opportunities if it so wishes.

In addition, trading in and out of property results in high transaction costs (round trip costs of circa 8%) that will need to be taken into account and a Qualified rating means we believe that the manager, although not best in class, is still competent.

However, a fund of fund approach has its limitations, most notability a lack of control for an investor to set the property strategy and restricting the opportunity set or not being able to take higher conviction positions where felt to be appropriate.

We would therefore recommend that if the Committee decide to increase the allocation to property that they consider investing directly into specific funds rather than increasing their allocation to the Aviva fund of funds product.

This paper explores a number of different opportunities beyond UK core commercial property for the Committee to consider. These should be selected based on the wider investment requirements of the Pension Fund since they have very different characteristics and can offer inflation linkage, more fixed income like returns, or high returns from intensive active management and leverage.

Should our understanding of the appetite within the Committee to invest in higher return seeking property opportunities be correct, strategies such as Private Rented Sector, Value-Add and Opportunistic property funds, could be considered appropriate for increasing the Pension Fund's allocation to the asset class. These strategies, whilst having the potential for higher return, are also higher risk. Similarly, higher yield property debt could also be considered.

There is also merit in considering allocating to more income-return generating opportunities, if the Committee prefers a lower-risk approach to diversifying the Pension Fund's property allocation.

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Introduction

The investible property universe open to UK pension schemes has grown rapidly over the past few decades and increasingly schemes are allocating beyond core UK commercial property.

Today UK pension schemes can allocate to strategies which have a focus on security of income with bond-like qualities or to growth strategies which have a much greater emphasis on value creation and use leverage. In addition, it is more common and increasingly easy to invest in property outside of the UK into mainland Europe, the US and even Asia.

The breadth of opportunities means that more than ever pension schemes can tailor their property portfolios to fit their wider investment and funding objectives as well as diversifying away from being overly reliant on UK core commercial property.

This purpose of this paper is to comment on the Fund's existing property investments and introduce a number of alternative opportunities that the Committee may wish to consider if they were to expand their property allocation.

When discussing these alternative property asset classes, we have split them broadly into two categories: income focused and growth focused.

Comment on the current portfolio and fund of funds investing

The Fund's current property allocation is invested in the Aviva UK Real Estate Fund of Funds product.

This product is rated Qualified by Aon Hewitt, which means that although we have managers which we rate with higher conviction, we believe the product is fit for purpose.

The product invests across a number of specialist sector funds (industrials, retail and student housing) and diversified core property funds. This portfolio would be considered core to core plus and is UK focused.

The benefits of using a fund of funds is that an investor gains exposure to more funds and underlying properties than would be possible if they invested in funds directly; drastically reducing the governance requirement and scale needed to increase diversification. As at the 31 March 2017, the product was invested across 21 underlying funds with a combined Gross Asset Value of c. £20 billion across 915 assets.

However, the product has not had significant traction with investors and is small with a net asset value of only £167.7 million as at 31 March 2017.

There are notable downsides to using a fund of funds manager. In particular products like this one which broadly matches its benchmark in terms of sector exposure and invests across many underlying funds rather than fewer high conviction funds will, on balance, find it difficult to consistently outperform the benchmark. This is especially true given the additional layer of fees (0.2% per annum) that Aviva charges on top of the underlying fund manager fees.

As a case in point for this specific product, the manager has outperformed its benchmark by 0.3% net of all fees over the year to 31 March 2017, but underperformed by 0.7% per annum over 3 years and 0.4% per annum over 5 years.

Additionally, investors do not have any control over the product's strategy and therefore cannot easily allocate to other opportunities such as the private rental/build to rent (residential) sector, long lease funds, property debt and higher return seeking opportunistic funds, all of which we introduce later.

Investors are therefore reliant on the allocation skills of the manager where the investment focus will typically exclude (or not take material positions in) a number of opportunities where we see a strong investment case. Additionally, in many cases, the fund manager will not have the resources, mandate or skillset to consider certain strategies.

The Aviva fund has allocated to debt funds in the past, although they have been small allocations and unlikely to make a meaningful impact on overall performance. One of these debt managers was ICG-Longbow which we rate highly, although their Fund II which Aviva invested in has now returned its capital to investors.

Aon Hewitt does not directly rate and monitor all of the underlying funds that the product invests in, but we do rate all of the core funds where it has a material exposure. These are managed by BlackRock, Lothbury, Schroders, CBRE Global Investors and Aviva. The first three of these funds are buy-rated, while CBRE and Aviva are both qualified.

With the exception of the Aviva Pooled Pensions Property Fund, which we are monitoring closely following the departure of the fund manager Richard Peacock in 2016 and continued underperformance, we have no major concerns with the other core managers.

The table below summarises the key differences between investing directly in pooled funds versus via a fund of funds approach.

Key differences between investing in property via Fund of funds and directly via pooled funds

Characteristic	Fund of funds	Direct fund investments
Control over strategy	None	Total
Diversification (number of funds)	More	Less
Governance burden	Less	More
Allocation to alternative opportunities	Unlikely (where they are made, unlikely to be material position for investor which wishes to have meaningful exposure)	Possible
Liquidity*	Lower	Higher
Fees*	Higher (given overlay fee)	Lower

*on a like for like basis

Alternative property asset classes:

In this section of the report we introduce a number of alternative property-related opportunities. We categorise them between those that derive most of their return from capital appreciation, where income is less certain, and those which derive most of their inherent value and returns from their income stream. The security and nature of any income can vary greatly.

Capital Appreciation strategies that the Committee can consider include:

- **Private Rented Sector**
- **Value-add / Opportunistic Fund**

Income producing strategies that the Committee can consider include:

- **Ground rents**
- **Senior property debt**
- **Long lease property**
- **High yield property debt**

Further information on each of these, including their level of security, is included in Appendices 1 and 2, respectively.

The table below summarises the characteristics of each strategy.

Characteristics of alternative property-related opportunities

	Returns from:	Net returns (manager targets)	Explicit Inflation linkage	Closed / open ended	Leverage	Annual management charge	Time to fully invest
Core	Balanced	5%	No – some implicitly	Open	No to little (<30%)	c. 80bps	< 1 year
Ground rents	Income	4-4.5%	Yes if commercial	Open	No	20-50bps	1-2 years
Senior property debt	Income	3-8%	None	Closed	No	40-100bps+ performance fee (higher return funds only)	1-2 years
Long lease property	Income	5-6%	Yes	Open	No to little (<30%)	25 – 50bps	< 18 months
High yield property debt	Income, potential capital gain	8-10%	None	Closed	No to moderate (<50%)	125bps + performance fee	1-2 years
PRS	Balanced	6-8%	No – some implicitly	Open	No to little (<30%)	70 – 100bps	1-2 years
Value add	Mostly capital gains	9-12%	None	Closed	Low (30%) to moderate (50%)	100-150bps + performance fee	2-4 years
Opportunistic	Nearly all capital gains	14-15%	None	Closed	High (50% - 65%)	150bps + performance fee	2-4 years

Going global

Historically UK pension schemes have tended to invest in Europe if looking to invest overseas, either in core property or in opportunistic funds. Until recently it was not tax efficient to invest in the US and the wider Asian market was not sufficiently developed.

UK pension schemes can now invest across all the asset classes discussed in this paper in the UK and also overseas. DTZ estimates that only 28% of the global $29 trillion commercial real estate market is European, with North America at 45% and Asia at 22%.

Investing globally significantly increases diversification within a property portfolio. For example, the established US core funds tend to be around $20 billion in size, dwarfing any UK or European fund. They also tend to have a much greater allocation to alternative sectors such as residential and self-storage.

Although US tax rules are changing, making overseas investment in US real estate more attractive, there continues to be significant tax issues and other restrictions when considering US property. Investing in US core funds should result in minimal tax leakage though. In general, given these points and the current market cycle in the US, we would recommend that our UK clients only consider exceptional opportunities at this time. We would also add that the US and UK markets have been quite closely correlated historically.

In Asia, we prefer gateway cities in established, developed nations. On balance, however, we do not believe there is a compelling reason to invest in this region because you will need to take greater country, currency, property and political risks for little or no return gain relative to the UK or mainland Europe.

A number of international fund managers now have global direct core offerings and historically global exposure was limited to investing in listed real estate.

A major hurdle for investors investing in overseas property is the impact of currency swings which can weaken or strengthen returns.

Given the potential issues around the effects of currency and tax leakage, we tend to recommend that smaller-medium sized UK clients look to invest in the UK and Europe.

Implementation Considerations

Property is an expensive asset class to invest in with significant round trip costs. In addition there can be a substantial opportunity cost since it takes time, sometimes years, to fully invest in or exit a fund. This means that changes to an investment strategy will need to take into account these costs and weigh up if, on balance, it is the right decision to take.

Many of the opportunities we have highlighted in this paper will take time to get full exposure to, in some cases a number of years. During this period the assets allocated to the funds will have to be invested somewhere. In addition, these funds are likely to call capital at different times, rather than in one go. Managers will provide a least 10 working days' notice, but there needs to be a governance structure in place to deal with capital calls and also distributions once invested.

Property debt and value-add/opportunistic property can only be accessed

via closed-ended fund structures. Closed-ended funds exist because they give the manager certainty over the amount of cash they have to invest and also allow the manager to get on with the execution of business plans without the worry of redeeming investors.

This is a benefit to investors; however, the drawback is that liquidity is very low, although investors will have ability to sell their interest in the fund on the secondary market or to other investors in the fund. However this might not be possible and the price an investor would achieve is uncertain at the outset.

The life of these funds will vary, but will typically be 7 years from the final close. Many of these funds will also have higher fees compared to core real estate funds, albeit while targeting much higher returns.

Closed-ended funds will also have minimum investment sizes, typically around £10 million, although managers might waiver this and we have seen managers accept £5 million.

Recommendation

In our opinion, UK pension schemes should have a sizeable allocation to core UK commercial property, before they consider alternative asset classes.

For this reason and because of the high transaction costs associated with moving property allocations we would not recommend that the Fund divests entirely from the Aviva UK fund of funds product and that a material exposure is maintained.

We do, however, believe that there are compelling alternative property opportunities that should be considered.

With the long time horizons of the Pension Fund and the particular interest of the Committee in property investments, investing in growth focused strategies, such as Private Rented Sector, Value-Add and Opportunistic property funds, could be considered appropriate. These strategies, whilst higher risk, also have the potential for higher return. Similarly, higher yield property debt could also be considered.

These strategies cannot be accessed easily via a fund of funds product and even if they are, the manager is unlikely to have the resources or capabilities to successfully choose the best managers. However, we would recommend that any allocation to these strategies is diversified by style and vintage.

Appendix 1 - Growth focused property strategies

Below are details of capital appreciation oriented property strategies that the Committee can consider, as listed in the main report.

Private Rented Sector (6 to 8% net IRR)

The private rented sector (PRS) is a new asset class in the UK which typically invests in large, purpose-built residential buildings let to individuals on short term tenancies. Currently, the majority of landlords in the UK are buy-to let investors owning a few homes and institutional investors only make up a few percent of the UK housing stock.

This is in stark contrast to Europe and America where institutional investors typically own between 15 and 50% of the residential letting pipeline. Since there is not much existing purpose built PRS stock in the UK, funds are looking to develop new schemes which are typically around 75 to 250 units in size.

The managers of these funds have a clear vision as to how PRS should be run in the UK, adapting models seen in the US and Europe. These typically include providing concierges, having full control over the fittings of the units, including green spaces and amenities and helping create fit for purpose property managers.

The majority of the funds do not take planning, construction or development risk and the only risk they take is the letting risk once these buildings are complete.

PRS is looking compelling because of the supply and demand dynamics across the country; especially in the South of England where house price to earnings ratios are at record highs and the average age of a first time buyer is now around 35. This means more people are renting than they were at the start of the millennium and this is creating upward pressure on rents.

Although these managers are looking to create a premium product relative the existing rented housing stock which is often poorly managed and kept, they are not charging a premium on their rents.

The majority of the return is expected to come from rental income and from rental income growth and managers who are targeting 6-8% net returns are doing so with modest leverage. Historically residential rental growth has been a much better match for inflation than commercial properties.

These are open ended funds, but this has been a popular asset class. Queues into funds have increased and because the properties are being purpose built, the time to be fully drawn down is around 12 to 24 months depending on the fund.

CLASSIFICATION – Medium risk, provide diversification and have a role in a client's growth portfolio; therefore similar to UK core commercial property.

Value-add / Opportunistic Funds (10 – 15% net IRRs)	Unlike core funds, value add and opportunistic managers look to purchase assets that have been historically undermanaged and look to create value through intensive asset management or repositioning of the asset and then sell them for a significant capital gain. These funds will use leverage to enhance returns. Value-add funds typically take less risk than opportunistic funds. They tend to create value through asset management and look to create a better quality property that can then be let at a higher rent. These assets could be shopping centres or offices and the manager will target assets that historically have been poorly managed. In many cases the assets will continue to be largely income producing while the work is being carried out. Once the asset management and the business plan are complete the manager will sell the asset. Opportunistic funds take greater risk than value-add focused funds. As well as asset management of properties, they will also undertake high risk projects such as speculative development or buying operational business backed by real estate. Opportunistic managers will also tend to use more leverage and nearly all the return is expected to come from capital gain rather than income. When investing in opportunistic managers, investors should ideally do so by spreading their allocation over different vintages (year of the fund launch). These funds are structured as closed-ended funds with limited liquidity and fund lives of around 10 years. **CLASSIFICATION – Higher risk, but with the opportunity to generate very attractive returns which will be driven largely by capital gains.**

Appendix 2- Income focused property strategies

Below are details of income producing property strategies that the Committee can consider, as listed in the main report.

Ground rents (4 to 4.5% net IRR)

The owners of residential and commercial ground rents effectively own the land and receive a rent from the owner of the building on the land. The lease length is usually between 99 to 999 years.

The rent paid usually increases in a clearly defined way at set times in the future. For residential ground rents this might be the ground rent payable doubling every 20 years or increasing by a fixed amount every 5 years or even being linked directly to RPI, again reviewed periodically.

Commercial ground rents might be structured to be linked to inflation, RPI or CPI, typically with a cap and collar, and might increase every year or every five years.

Ground rents are highly secure in the sense that they are extremely well collateralised; i.e. the capital value and associated income stream of the ground rent are significantly smaller than the capital/rental value of the underlying property which it is secured against. By way of example, for residential ground rents, the value of the actual leasehold dwelling is typically around 25 to 30 times higher than the value of the associated ground rent. For commercial ground rents, you would typically see capital value cover of 3 to 5 times.

It is highly unlikely that the ground rent would not be paid as the beneficiary (i.e., owner/mortgagee) of the subordinate interest would risk losing ownership that could theoretically be forfeited in the event of non-payment of rent. This would result in a large windfall for the owner of the ground rent. It is because of this that ground rents are always paid.

Because of their long duration and security they are well sought after by institutional investors and are very hard to source. It also takes time to build up a ground rent portfolio.

Dedicated funds do exist, but it is most likely that investors would gain exposure via a long income fund which would target some exposure commercial ground rents.

CLASSIFICATION - we would classify ground rents as very secure investments.

Senior property debt and property whole loans (3% to 8% net IRRs)

Before 2008 practically all of the commercial property financing in the UK was from banks. This all changed after the financial crisis as banks retreated from the market and looked to work out the bad loans on their balance sheets. In addition, banking regulation changes have made it more challenging for banks to lend against certain types of properties and for loans where the borrower wishes to borrow more than 60-65% of the value of the property.

This has created an opportunity for institutional investors, mostly insurance companies and pension schemes, to step in and provide debt for refinancing

and new acquisitions. There are now a number of established real estate debt fund managers who are regularly launching funds available for institutional investors in this space.

Senior debt and whole loans debt strategies are essentially first charge mortgages, where the loans are secured on the underlying properties. This means in the unlikely case that a borrower defaults, the lender has the right to step in and take over the property and sell it to recover the loan interest and capital. The loans will also have covenants in place to protect the lender before a default occurs and will include the ability to sweep all the cash (i.e. rent) from the underlying property into a reserve account to ensure that interest and capital repayment obligations are met.

In terms of definition, senior loans typically have a loan to value up to 60-65% while whole loans, although still a first mortgage, have a higher loan to value, up to around 75-80%. This means that for a whole loan, property values would need to fall by around 20% before the loan is at risk of a write-down.

Net IRRs are around 3 to 5% for senior loans and 6 to 8% for whole loans. The returns are driven by the quarterly payable coupon; however there are other fees which will benefit investors, including arrangement and exit fees. Because these are bilateral loans, they are not marked to market, and instead are held at par value unless impaired.

Property debt is currently looking very attractive from a returns perspective compared to UK core property.

These funds are structured as closed-ended limited partnerships which are well suited as a vehicle for holding real estate debt investments with limited liquidity and a life of typically 7 to 8 years.

CLASSIFICATION – we would classify senior debt as very secure and whole loans as secure

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Long lease property (c. 5% to 6% net IRR)

Long lease property funds have grown in popularity and size since their launch around a decade ago; the main pooled funds available are today between £1 and £3 billion in size.

They are very core like in the types of buildings they acquire, but the popularity of these funds with pension schemes is due to the fact that underlying properties are let on 20 year plus leases to investment grade tenants with explicit inflation linkage. These funds are often considered as alternative matching assets given their long characteristics; although they will not change value in the same way as an index linked gilt would and therefore are not a true LDI matching asset.

These funds will predominantly invest in long leases, although they can invest in other long secure income assets including ground rents. In addition to providing explicit inflation linkage, they will invest in sectors such as government or local authority buildings, healthcare, leisure, hotels and supermarkets and can therefore offer some diversification benefits relative to a typical core fund.

Since inception, these funds have broadly produced returns in line with the wider commercial property market, but with less volatility. They are open ended funds however due to their popularity historically it has taken around

9 to 18 months to be fully invested.

CLASSIFICATION – whilst these assets generally provide secure income cash flows which are typically linked to inflation, capital value growth will still have correlation with the wider property market albeit with less volatility.

Higher yield property debt (8 to 10% net IRR)

High yield property debt shares many of the same characteristics of senior debt/whole loans discussed earlier; however the funds and loans differ in a number of important ways and this asset class could also have been placed in the next section which discusses growth assets.

These funds will invest in mezzanine debt, which although more senior than equity, ranks behind the senior lender in terms of security – they do not have a first charge on the property. The senior lender for example might have a loan to value of 65%, while the mezzanine lender will have provided finance to the borrower for 65% to 80% of the property's value. This means that if the property value falls by 35% the mezzanine investor will have lost all of their capital. However, if the property falls 20%, only the equity investor will lose their money.

To compensate for this greater amount of risk, a mezzanine investor requires more return and this is reflected in a higher coupon and also greater ancillary fees for arranging the loan.

Higher yielding funds might also invest in high yielding senior bridge loans, use leverage or structure loans to participate in the upside of the property.

Because of the higher risk nature of mezzanine investing, we would recommend that mezzanine funds make up part of a wider debt portfolio which also allocates to whole loans.

These funds are structured as closed-ended funds with limited liquidity and fund lives of around 7 to 8 years.

CLASSIFICATION – Higher risk, but with reasonable downside protection with the target return significantly underpinned by the property's rental cash flow.

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