Consulting

Property Portfolio Restructuring

London Borough of Croydon Pension Fund

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Prepared for

The Pension Committee

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Executive Summary

Summary

The Officers of the London Borough of Croydon Pension Fund (the "Fund") carried out a strategy review and recommended an increased allocation to Property amounting to 10% of total Fund assets. This was agreed by the Pension Committee. We are supportive of that decision and believe there are attractive opportunities for investing in UK property. These opportunities combined with the experience to date with the European property funds, lead us to believe that the focus under the new strategy should be on the UK market.

There are several interesting opportunities in areas outside of traditional property investing such as ground rents, index linked property leases, property debt and opportunity funds. These are covered in this paper and we believe the Pension Committee needs to agree which of these opportunities it would like to incorporate into a new Property portfolio.

We believe a "Core - Satellite" approach to the Property portfolio would be appropriate with potentially a 80/20 split between the two.

The "Core" portfolio could comprise investments in UK core property funds, ground rents and index linked property.

The "Satellite" portfolio could invest in UK property debt and opportunistic funds.

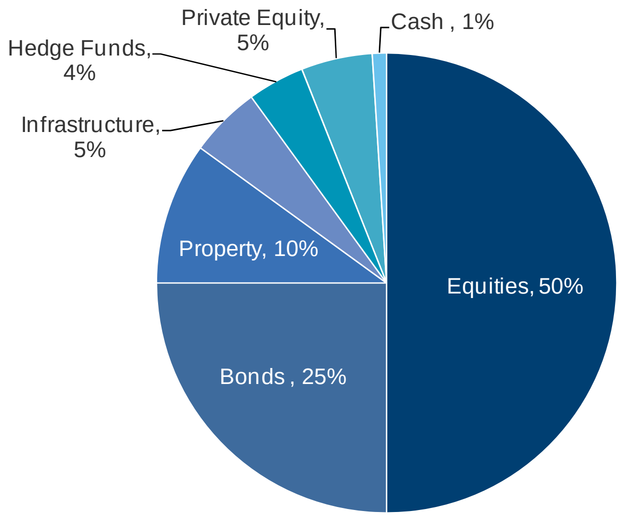
The route for implementing the new strategy will be dependent on the number of managers the Pension Committee and Officers are comfortable with monitoring on an ongoing basis. We see no reason why the current Schroders mandate cannot form the main part of the core Property portfolio. Schroders can be complimented by a small number of managers to provide access to the relatively low risk area of ground rents and index linked leases. The satellite portfolio would be comprised of investments in return seeking property related funds such as property debt and potentially opportunistic funds.

The next steps would be to agree on the areas that the Pension Committee would feel comfortable investing in, how the investment should be allocated between "Core" and "Satellite" and the number of managers that should be appointed.

Introduction

Background

At the previous Pension Committee meeting on 5 March 2013, the Officers presented an investment strategy review paper. The Pension Committee approved a revised investment strategy which was as follows:



The purpose of this paper is to discuss the property portfolio.

This paper presents various options available to the Pension Committee in terms of the future structure of the Fund's property portfolio. The paper outlines potential structures and how the mandates could be split across investment managers.

The intention is to discuss this paper further at the 14 May 2013 Pension Committee meeting and agree how the revised property portfolio should be structured and implemented. This will include agreeing on the number of managers and how these will be selected.

Current Position

The Fund currently has a 7% strategic allocation to property, consisting of both UK and European investments. A breakdown by manager and region is shown in the table below.

Manager	Fund	Region	AUM (£m)	Proportion of Fund Assets (%)
Schroders	Multi Manager	UK	26.9	4.1
Standard Life	European Property Growth Fund	Europe	4.7	0.8
Henderson	Indirect Property Fund	Europe	6.4	0.9
Total			**38.0**	**5.8**

Source: Managers. Valuations as at 31/12/2012. Totals may not sum due to rounding.

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The UK portfolio is managed by Schroders via a "multi manager" structure meaning that the Fund invests indirectly with a number of underlying managers. Schroders has broken down the portfolio into Core (comprising five underlying funds) and Value Add (comprising four underlying funds).

As at 31 December 2012 there was £26.9m invested with Schroders within the UK property asset class, representing 4.5% of total Fund assets.

The European portfolio is split between Standard Life and Henderson, which together form 2.7% of the Fund's overall assets. At recent meetings the Pension Committee has discussed at length European property. It has been agreed that the focus should be on UK property going forward and that the two European holdings should be liquidated as and when suitable opportunities arise.

The investments with Standard Life are made through the European Property Growth Fund (EPGF) and totalled £4.6m at 31 December 2012. Our property specialists in our manager research team have been working closely with property managers to see if there is an opportunity to redeem from this fund at satisfactory prices. The EGPF fund is semi open ended but there is currently a queue to exit and some uncertainty as to how long it will take to redeem. They expect that current market conditions would allow an exit from this fund at a discount to NAV in the range NAV-10% to NAV-15%.

Following multiple redemption requests, the Henderson Indirect Property Fund was placed into special measures. Aon Hewitt has communicated all steps in the development of proceedings which led to dual pricing in the form of a Net Asset Value (NAV) and a Net Realisable Value (NRV). Any redemptions from the fund would be at the NRV which is priced at a significant discount to the NAV. We maintain our view that the Fund should not redeem its investments with Henderson at the current time.

The strategic case for property

We continue to believe that there are still good opportunities for long term investors to buy property at yields well above those of corporate bonds (with the same company as tenant). Property will face headwinds from internet shopping, remote working, tenant defaults and a sluggish economy, but we believe that property prices already make allowance for these factors.

In the table below, we set out our in-house long-term assumptions for the expected returns and risks of various asset classes as at 31 March 2013. From the table it can be seen that we expect property to produce attractive returns, with a risk profile in-between those of fixed income assets and equities. These points serve to support the Pension Committee's decision to increase the Fund's allocation to UK property.

How does UK property compare to other asset classes?

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	UK Property	UK Equity	Index-Linked Gilts	Corporate Bonds
Expected Return (%)	7.3	8.0	1.5	3.2
Volatility of Return (%)	16.0	22.5	9.0	9.0
Correlation with Property	1.0	0.4	0.1	0.1

Decisions made

A summary of the decisions made by the Pension Committee to date is shown below:

- Increase the proportion of Fund assets invested in property to 10%. The increase will initially be funded from the cash portfolio.
- The portfolio will have a UK only focus over the longer term.
- The core portfolio will comprise the Schroders investments, which will be retained and possibly added to given the increased allocation to UK property.
- Other asset classes such as ground rents and property debt will be considered to compliment the Schroders investments.

Decision to be made

The Pension Committee has expressed its interest in other areas of property investment such as long lease property, ground rent and property debt. These all have different risk and return profiles. We have provided further information on these opportunities in this paper (and our separate papers titled "The case for investing in UK Property Debt" and "UK Commercial Ground Lease Investments").

After having considered these potential areas of property asset classes, we believe there are three main decisions that the Pension Committee will need to make:

1. Which new asset classes within property should be included in the portfolio to compliment the core Schroders investments?
2. How will the new portfolio be structured and what will be the weightings within the portfolio between different asset classes?
3. How will the new portfolio be implemented? Do new managers need to be appointed to manage the new asset classes within the portfolio or can managers already known to the Officers/Pension Committee be used?

Investment Opportunities

Schroders Core

The Schroders mandate is a "multi-manager" mandate and as such the Fund is indirectly invested with a number of underlying funds and managers.

The underlying funds are shown in the list below. Schroders split the funds into two portfolios; "Core" and "Value Add".

Core:

- Blackrock UK Property Fund;
- L&G Managed Funds Property Unit Trust;
- Standard Life Pooled Pension Property Fund;
- Palmer GVA Unit Trust;
- Rockspring Hanover Property Unit Trust.

Value Add:

- Hansteen UK Industrial Property Unit Trust;
- Henderson Central London Office Fund;
- Henderson UK Retail Warehouse Fund;
- Real Income Fund.

Schroders have oversight to switch the amount invested in each of these underlying funds. The manager will take into account several considerations when balancing between the underlying funds. Schroders multi manager capabilities are currently "BUY" rated by Aon Hewitt's manager research team. One of the benefits of this multi manager approach is that that manager will make decisions on altering the exposure to each of the above funds and therefore this does not require much time and governance input from the Pension Committee or Officers. This comes at a cost in terms of the fees paid to the multi manager.

The view of our research team is that this overall portfolio managed by Schroders will provide the Fund with overall property market exposure through well regarded funds which can add value relative to the market.

The Pensions Committee has two options:

1. Retain the current multi manager structure with Schroders. There is scope to increase the assets held with Schroders given the increased allocation to property.

2. Terminate the multi manager structure and for the Fund to allocate directly to some of the underlying funds. Aon Hewitt would be pleased to help with this, but it will require a greater time commitment from the Officers and the Pension Committee.

All things considered, the Pensions Committee may wish to keep with the current multi manager structure with Schroders, at least for the time being, given its favourable rating and the fact that it lowers the governance requirement of the Committee and Officers for a relatively small part of the overall Fund.

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Ground Rents

At the meeting on 5 March 2013 the Committee discussed ground rents as a potentially attractive area within the property asset class. A separate note is provided which explains Ground leases in more detail. A summary is provided below.

How it works

Aon Hewitt has identified freehold commercial ground rents as an opportunity offering long-dated cash flows (in excess of 100 years) with good linkage to inflation albeit with a higher yield than index-linked gilts. The key points of ground rents are as follows:

- The investor will own the freehold of a property subject to a ground lease.
- A ground lease is a long lease, typically 100 years or more, granted by the freeholder on a plot of land (or land and buildings) in return for an annual ground rent. The ground rent is typically 5-10% of the income from the land and buildings.
- At the end of the lease the land and building normally revert back to the freeholder.
- We have a preference for commercial ground rents as opposed to residential ground rents because the latter is affected by potential enfranchisement under UK law (that is, the right for a tenant/s to acquire the freehold ground rent from the landlord).

Expected return

We would expect nominal returns of 5.0%-5.5% per annum net of fees (equivalent to a real return of 2.0%-2.5% per annum above our long term inflation assumption).

Whilst ground rents are traditionally reviewed to a proportion of the property's market rent or rent passing (historically with long dated review patterns, for example every 21 years), there are an increasing number of ground rent opportunities explicitly linked to inflation (usually RPI, but potentially other measures such as HPI or LPI) with shorter rent review cycles (annually or every three, five or seven years). Based on current pricing for freehold ground rents, we would expect an initial income distribution yield (net of all fees) of approximately 3.0%-3.5% per annum.

Level of risk

We consider ground rents to be at the lower end of the risk spectrum in terms of property related investment. This is because freehold ground lease investments offer considerable protection for the investor against both tenant default and falling rental values.

Unlike a default on sovereign or corporate debt (which might lead to a total loss of capital) a default by a head leaseholder could lead to the owner of the freehold ground rent receiving a significant capital windfall.

Overall

We believe Ground Rents have a role to play within the new property portfolio as a defensive part of the "Core" portfolio. The returns are stable and long term in nature.

Index linked/ long lease funds

Index linked property leases can act as an alternative to index linked gilts but could also form part of the Fund's property portfolio.

How it works

While an investor may not be able to secure a pure inflation hedging return from commercial property, there is the potential to receive an indexed rental income if the occupational lease is drafted to review rents in line with the retail or consumer price indices. The indexation clauses vary between leases with some applying floors and caps.

It can be argued that these assets form part of the normal property portfolio (i.e. a "Core" portfolio) and be bought if the manager believes that such property is attractive. However, although the initial rental on an index linked property has regard to general property market rentals, all future increases are related to the RPI and do not then relate to property market rentals until the lease terminates, or the tenant defaults.

Index linked leases are mainly found in the hotel, supermarket, care home and nursing home sectors. Since pension funds do not normally want to deal with the social issues and difficulties which can arise with care and nursing homes, it is only the first two sectors which tend to be seen in pension fund portfolios.

Expected return

Overall rates of return available on index linked leases range from about RPI + 3% for a supermarket in South East England to RPI + 5% per annum for a Premier Inn or Travelodge type hotel. Inflation can be subject to maximum and minimum values depending on the specific lease. Inflation may accrue annually or impact rentals at five yearly intervals, again depending on the specific lease. These yields compare favourably to those available on index-linked gilts (ILGs). Note that the fund manager will need to take into account purchase costs (which, as with all property, will be high) and the estimated end value (which can be negative) when assessing the value and attractiveness of an index-linked lease.

In some cases the investment will be by means of acquisition of an existing asset together with a lease (a sale and leaseback), and in others by an agreement to build the asset accompanied by a pre-letting agreement.

Risk

These types of property are very different to conventional properties in that they can be regarded more like a corporate index linked bond which happens to have additional security using a property. As such, although these assets might look attractive to committees as an alternative to index-linked gilts, they tend not to be attractive to property managers with standard property benchmarks. This means separate property portfolios for individual leases are needed.

Overall

We are supportive of index linked long leases and believe these would provide further diversification within the "Core" element of the property portfolio. The returns are stable and linked directly to inflation, giving the asset class similar characteristics to those exhibited by index linked gilts.

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Debt funds

Another area discussed at the meeting on 5 March 2013 was UK property debt. We have issued a separate note explaining this opportunity in more detail.

How it works

Investment in property debt is essentially lending a proportion of the value of a property, or portfolio, secured on the underlying asset value by way of a charge. The charge on the property allows the senior lender (or lenders of whole loans) to take possession of the property should the borrow default on the terms of the loan, for example failing to pay interest. Debt is usually divided up into different offerings which have different levels of security - the more secure your investment the lower the return you are expected to receive.

- **Senior debt** is structured to be the least risky layer and will normally extend to a maximum of 60% of the property value. Senior debt has first charge security and is paid in priority to other layers in the event of borrower default.
- **Mezzanine debt** is provided to augment senior debt with a second ranking charge, and may take the total debt “stack” (or whole loan package) up to 75%-80%. Mezzanine debt often comes with a profit participation feature on any capital value uplift achieved at exit.
- **Whole loans** are a combination of senior debt and mezzanine debt.

Expected return and risk

The table below sets out the three main types of loan, what the characteristics are for each and the anticipated lifetime net return.

Debt Fund Structures

Type of loan	Loan structure characteristics	Anticipated lifetime net return (per annum)
Senior debt	Most secure debt layer with coupon payments driving return. The borrower will also likely pay an arrangement fee and may be penalised in the event of an early exit. Coupon of circa 6-7% per annum.	5%-6%.
Mezzanine debt	High coupon yield of c14-15% and can provide profit participation on exit/re-financing.	12%-13%.
Whole loans	Combined senior and mezzanine debt, coupon yield of c10-11% and can provide profit participation on exit/re-financing.	c.9%.

At the height of the UK property market in mid-2007, a typical senior debt arrangement would have been circa 80% of the property value with mezzanine debt taking the total debt stack to 90-95%, the balance being the equity contribution from the investor. Consequently, there was significantly less downside risk protection to debt provider(s) then than there is today.

The investors that will lose their money first if the value of the property falls are the equity investors. As such, a senior debt investor can accommodate a value fall of at least 40% without any loss of capital, while

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a mezzanine investor is protected from the first 20% or more of any value fall.

Since its peak, the property market has undergone c.35% downwards correction in underlying property values making property valuations look more attractive on a long term basis.

Overall

We believe there is a compelling case for allocating a proportion of the overall property portfolio to UK Property Debt Funds. This part of the portfolio would be considered return seeking and therefore should be classified within the "Satellite" allocation. The return is at the higher end of the spectrum for property related investments.

Opportunistic Funds

Another area which investors have considered is opportunistic property funds. These should be considered as return seeking.

How it works

In recent years there has been polarisation in the market between prime and secondary assets. This has largely been driven by the risk averse behaviour of investors following the financial crisis and prolonged period of uncertainty. This propensity to hold safer assets has been at the expense of non-prime assets in the property universe.

These factors mean that currently secondary commercial property is attractively priced relative to historic valuations. This in turn means that there is significant divergence between prime and secondary property yields (Appendix A contains charts showing this). There is therefore an opportunity to take advantage of the large pricing gap that has developed.

Expected return and risk

Investment managers in the opportunistic space will focus on assets from distressed sellers and/or on off-market opportunities. These will generally be assets which exhibit one or more of the following characteristics:

- have been poorly managed;
- there is a need for capital expenditure and/or intensive asset management;
- the tenant/s are perceived to be at risk;
- there is latent improvement potential.

There is therefore opportunity for the manager to increase the value of the underlying properties. The exact risk and return profile will depend on the nature of the underlying fund but this should be considered as higher up the risk/return spectrum.

Overall

Opportunistic property funds have been considered by some of our clients. This is a very specialist area and if there is interest, we suggest the Pension Committee invite a manager to present on its fund, prior to investment. As the returns are at the higher end of the spectrum, we recommend a smaller allocation within the "Satellite" portfolio to sit alongside a large "Core" portfolio.

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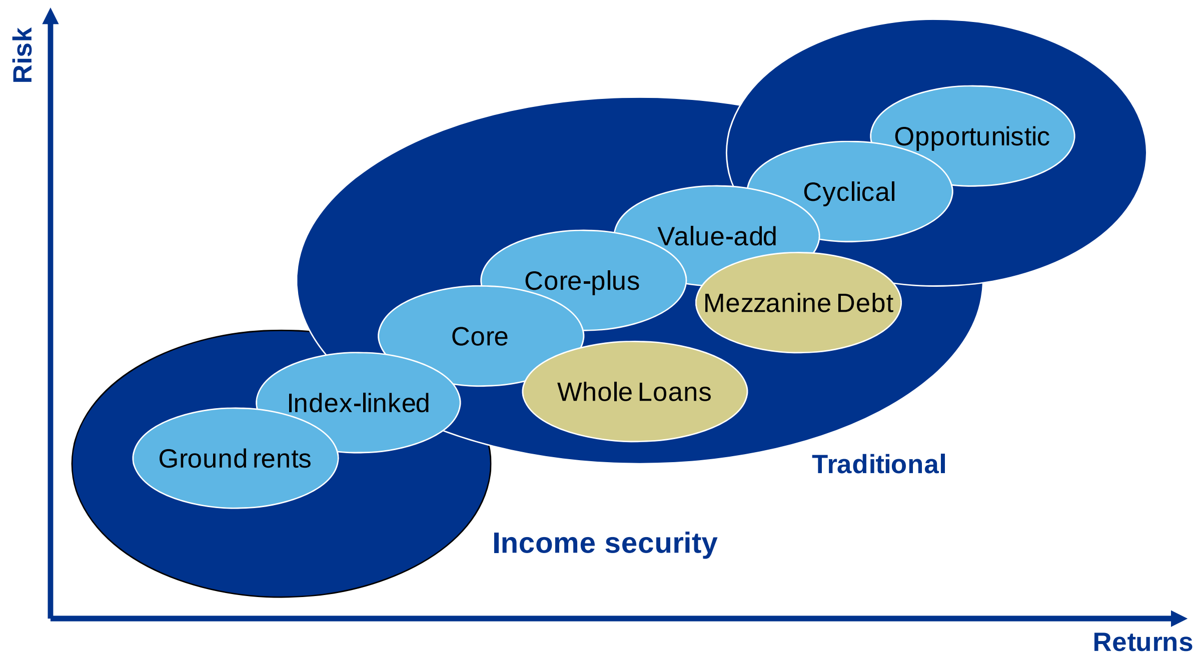
Combining asset classes

The diagram below shows how the different asset classes in this paper relate to each other on the risk/return spectrum.



Overall property portfolio

The Pension Committee has not carried out any modelling work in relation to setting the investment strategy and has no explicit risk/return target at the overall Fund level or the Property portfolio level. This decision to increase the strategic weighting to property to 10% was made on the basis that property would be a diversifying asset class from equities and bonds.

The 10% allocation to property represents c. £70m. It therefore makes sense to diversify the 10% exposure and we believe this is best achieved through a "Core-Satellite" approach as discussed earlier.

Using the diagram above we would expect the ground rents, index linked property leases and the multi manager portfolio to form the "Core" portfolio. Depending on the Pension Committee's comfort with property debt and opportunistic funds we would expect these to form part of the "Satellite" portfolio.

Whilst there is no precise way to devise the split between Core and Satellite we would suggest a starting point for discussion is 80/20 given that the main aim is to diversify the source of returns from equity and bonds.

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Portfolio Implementation

Overall Property Portfolio

There are several options available to the Pension Committee when it comes to implementing the new property portfolio. These options will need to be considered in the context of time and governance requirements for the Officers and Pension Committee to monitor and meet with all of these managers. It is worth re-iterating that this will represent 10% of the Fund's overall assets so fewer managers may be preferred to more.

As described earlier in this paper, Schroders is running a "multi-manager" mandate. This mandate has pre agreed risk and return target and Schroders manage towards this target by running two internal portfolios: core and value add.

There are two ends of the spectrum in terms of the revised property portfolio.

1. The implementation route that involves the lowest amount of governance would be to widen the remit of the Schroders multi manager structure and request that the manager builds up a portfolio to include all or some of ground rents, index linked leases, property debt and opportunistic funds. The cost for this implementation would however be relatively high as Schroders charge a fee on top of that charged by all of the underlying managers. Schroders also may not have the depth of resource to pick the most suitable managers in these alternative asset classes. Most of the flexibility would also be delegated to Schroders, limiting the ability of the Pension Committee to direct investments to particular areas. There would also be uncertainty about the timing of these investments.
2. The Pension Committee could take a more hands on approach, removing the multi manager structure and investing directly into a Core-Satellite portfolio which invests in ground rents, index linked leases, core UK property, property debt and opportunistic funds. This option offers greater flexibility, but may result in multiple managers being appointed which will increase the governance burden for the Officers and Pension Committee. A new manager search could be carried out through Aon Hewitt which avoids the OJEU process on the basis that these investments can often be accessed through pooled funds. This would be dependent on the view of the in house procurement team at London Borough of Croydon.

A third option could be to try and find a compromise between the two ends of the spectrum. Below we have explained how this could work.

Core

The "Core" portfolio could comprise ground rents, index linked leases and the existing multi manager portfolio, as shown in the diagram on the previous page. Together these could form up to 8% of the Fund's overall assets (using an 80/20 split between Core and Satellite).

The Fund would retain the existing multi manager portfolio with Schroders (at its current level) and allocate the balance of the 8% directly to an index linked leases fund and a ground rents fund.

Schroders do offer a real income fund that could be used to diversify the

Scheme's exposure to property asset classes within the UK, however we feel that there are better offerings from other managers in this universe.

There are several managers offering products in the Ground Rents space, one of them being Standard Life – an existing property and bond manager for the Fund. We are also aware of a range of Index Linked property funds, including those offered by Legal & General and Hermes.

We have been made aware of funds offered by many managers in a variety of areas, including those offered by Invesco Perpetual. However, the view of our property research specialists is that there are other managers (as mentioned above) that have better capabilities in these areas.

Satellite

The Fund does not currently access some of these "satellite" ideas such as property debt or opportunistic funds through the existing Schroders multi-manager approach.

Schroders has only one credible offering in these areas in our opinion and therefore external managers will need to be investigated in order to gain access to these ideas. We would recommend that one manager is appointed for each of these ideas.

The Aon Hewitt property research specialist team has seen products from Long Bow, M&G, BlackRock and Insight. There are also new funds coming to market in the near future. Aon Hewitt will be able to help the Officers appoint any new managers in these areas as we have carried out extensive research with the managers. How these managers are appointed may be dependent on the view of the procurement team at Croydon (i.e. with or without the use of an OJEU process).

Recommendation

We endorse the decision to increase the strategic allocation to property to 10% and to focus on the UK market.

We believe it is sensible to access different areas of the property asset class and our preference would be to construct some form of "Core-Satellite" portfolio. A sensible starting point may be an 80/20 split between the two.

The "Core" portfolio would consist of investments in UK core property funds, ground rents and index linked property.

The "Satellite" portfolio would invest in UK property debt and opportunistic funds.

The exact number of managers and how each idea is reflected in the property portfolio will be dependent on the views of the Pension Committee.

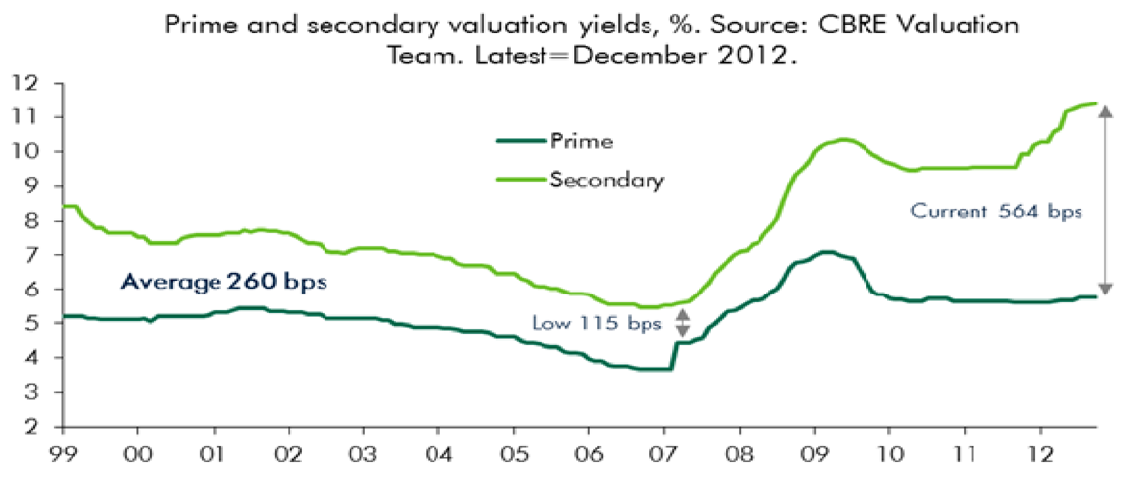
Next steps

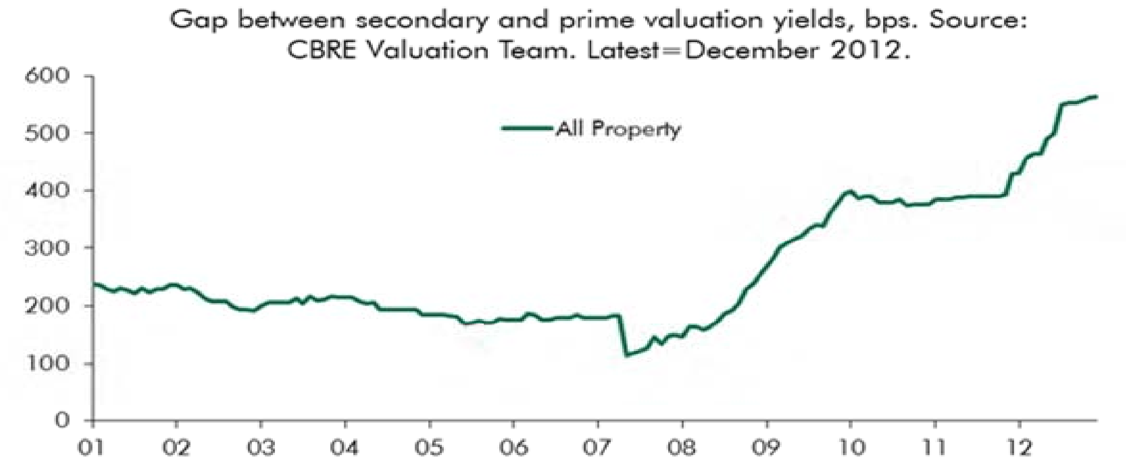
We look forward to discussing this paper with the Pension Committee at the upcoming meeting and agreeing how to implement changes in the property portfolio.

Appendix A

Opportunistic Funds

The charts below show the significant divergence between prime and secondary property yields as mentioned in the opportunistic funds section.





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