

AUDIT & GOVERNANCE COMMITTEE

29th October 2020

Report of the Executive Director Finance

REVIEW OF THE PROPOSED INVESTMENT IN PROPERTY FUNDS

Purpose

To provide an opportunity for Members to review the Council's Property Fund investment plans.

Recommendation

That Members recommend to Cabinet that the planned investments in property funds be deferred, with a review during Spring 2021 when the situation should be clearer, to inform future investment plans.

Executive Summary

At the meeting on 15th July 2020, Members of the Corporate Scrutiny Committee considered the Capital Outturn report for 2019/20 concluding before any further investments in property funds under existing delegations are made, that a review be carried out.

As the Committee nominated by Council for the scrutiny of Treasury Management functions, it was recommended to and approved by Cabinet on 30th July that the review be scrutinised by the Audit & Governance Committee to inform the Treasury Management Strategy Statement and Annual Investment Strategy Mid-Year Review Report due to be presented to Council in December 2020.

Following a Property Fund Manager selection exercise during 2017/18, supported by Link Asset Services, Council on 27th February 2018 endorsed the approach taken and approved the investment in a short list of Property Funds.

To date, the Council has invested £1.85m with Schrodgers UK Real Estate Fund and £2m with Threadneedle Property Unit Trust, total investment £3.85m – however, capital values have fallen by £291k since, mainly since 31st March 2020 (£163k). It should also be noted that investments in property are subject to fluctuations in value over the economic cycle and should also yield capital growth in the longer term as the economy grows.

Table 1: Fund Valuations	Investment	Valuation 31/03/2019	Valuation 31/03/2020	Valuation 30/09/2020
Schrodgers UK Real Estate Fund	1,848,933	1,897,716	1,884,412	1,796,118
Valuation Increase / (reduction)		48,783	35,479	(52,815)
Threadneedle Property Unit Trust	2,000,249	1,921,884	1,836,032	1,761,749
Valuation Increase / (reduction)		(78,365)	(164,216)	(238,500)
Total	3,849,182	3,819,601	3,720,444	3,557,867
Gain / (loss)		(29,581)	(128,738)	(291,315)

However, this needs to be balanced against the dividends received (which support the revenue budget). The Council received £147k in dividends from its property fund investments in 2019/20 (£108k in 2018/19), £255k in total compared to the valuation reduction of £129k over the same period.

Table 2: Investment Returns	Dividend Returns 31/03/2019	Dividend Returns 31/03/2020	Dividend Returns 30/09/2020	Estimated Return p.a.	
				%	
Schroders UK Real Estate Fund	48,118	56,638	27,300	3.0%	Half year only to 30/9/20 for 2020/21
Gain / (loss)	48,118	104,756	132,056		
Threadneedle Property Unit Trust	60,056	90,274	38,684	4.9%	
Gain / (loss)	60,056	150,329	189,014		
Total	108,174	146,911	65,984		
Gain / (loss)	108,174	255,085	321,069		
Annual % Return	2.8%	3.8%	1.7%	3.9%	
Cumulative Gain / (loss)	78,593	126,348	29,754		
Internal Treasury Management Return Achieved %	0.9%	1.0%	0.8%	0.7%	

The funds achieved a return of 2.8% in 2018/19 and 3.8% during 2019/20 compared to internal investments with banks and other Councils of less than 1% - and are forecast to achieve 3.9% in 2020/21.

The MTFS includes budgeted income of £300k for 2020/21 (£480k pa from 2021/22) arising from investment of the full £12m budgeted, however, due to uncertainty around arrangements for Brexit and the associated impact on the economy, and then the further uncertainty and questions over the potential outlook for future property fund returns as a result of the coronavirus, any further investment in property funds had been delayed until there is more clarity.

Review of the Situation since 31st March 2020

During March 2020, the majority of property valuation firms in the UK concluded unanimously that they were faced with an unprecedented set of circumstances on which to base a valuation judgement and thus were required to include a 'Material Valuation Uncertainty' clause to their valuations. This in turn meant that the Net Asset Valuation (NAV) valuation process for UK property funds as of Q1 2020 was also materially uncertain and therefore prices for subscriptions to, and redemptions from these property funds units would not be reliable. The result was that the majority of UK property funds suspended dealing. This was done in consultation with the Association of Real Estate Funds (AREF) and was notified to the Funds regulators. It is worth noting that the suspension was not a reflection of the liquidity but rather a market-wide valuation issue.

As time has progressed and more transactional evidence post the lockdown has become available it has become possible for valuers to feel more certain about the valuation of UK real estate. The Material Valuation Uncertainty clause has been lifted incrementally as valuers became comfortable with each sector having sufficient comparable evidence to have the clause lifted.

During September 2020 the Material Valuation Uncertainty clause was lifted from virtually all assets. This means that the majority of portfolios are now not subject to the Material Valuation Uncertainty clause, because valuers believe that they have enough transactional evidence to be reasonably certain of the level that these assets would trade at in the market. This in turn means the Managers have approved the lifting of the suspension of the Funds. The Funds will issue a reliable NAV based value on the September valuations, as opposed to an indicative NAV as was the case during the suspension period. Following the lifting of the suspension, Managers have also approved that dealing in the Funds will resume during October 2020.

Subscriptions and redemptions, previously suspended from March through September will be possible from October 2020 onwards.

The latest Investment Property Forum (IPF) Consensus Forecasts were revised down over the forecast horizon, with notable downgrades to next year's outlook. Capital Economics' views are broadly in line with the IPF in terms of sector rankings, but they take a different view on the impact of structural shifts in the office and retail sectors.

August's IPF survey of property forecasters showed views for this year have become slightly less negative, with expectations for total returns improving from minus 8.1% to minus 7.4% (table 3 and Chart A below). Given that the MSCI data (providers of property performance figures) has so far turned out slightly better than expected since lockdown, at least outside of retail, this upgrade was perhaps not surprising.

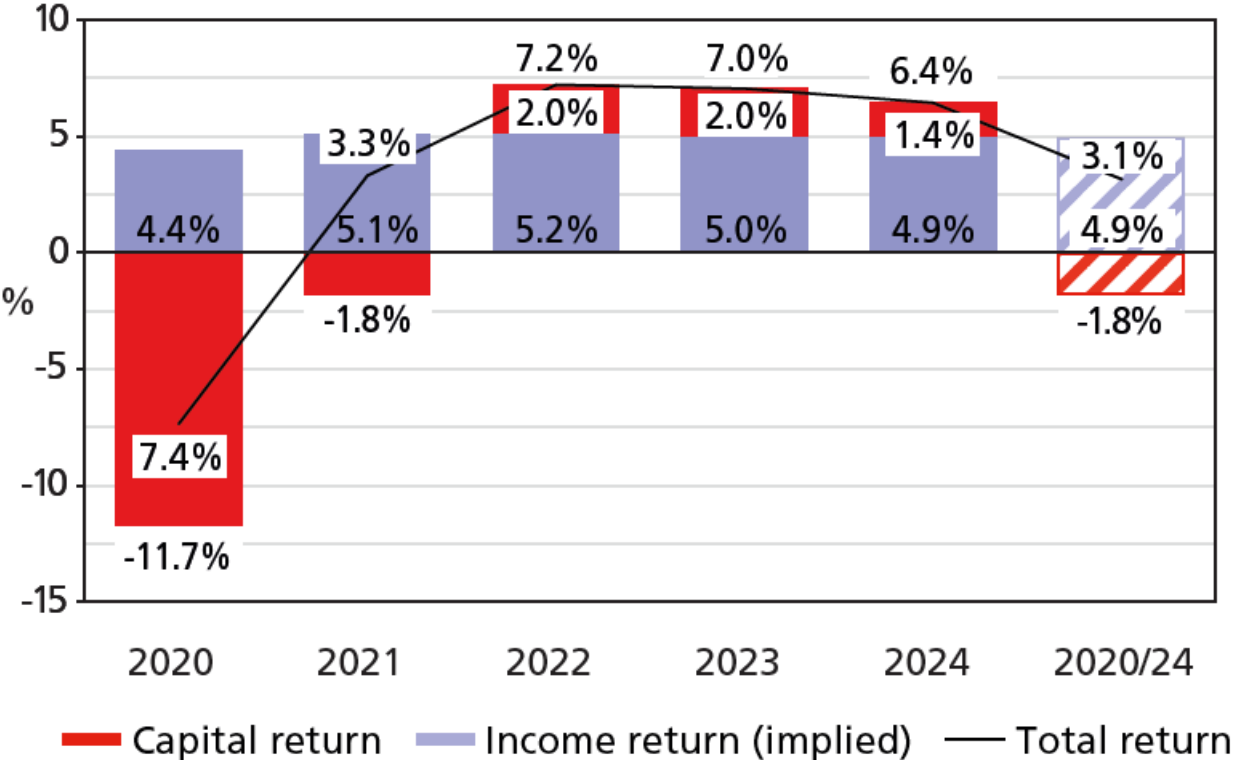
Table 3: Forecast Returns

	2020			2021			2022		
	Rental Values	Capital Values	Total Returns	Rental Values	Capital Values	Total Returns	Rental Values	Capital Values	Total Returns
IPF Consensus									
November 2019	-0.2	-2.2	2.5	0.7	0.1	4.9	1.2	0.8	5.7
February 2020	-0.1	-1.4	3.5	0.4	0.2	5.0	0.9	0.4	5.2
May 2020	-6.3	-12.4	-8.1	-1.3	0.2	5.3	0.8	2.9	7.9
August 2020	-5.0	-11.7	-7.4	-1.9	-1.8	3.3	0.7	2.0	7.2
Capital Economics									
May 2020	-4.5	-10.6	-5.5	2.2	4.7	9.6	1.6	2.5	7.5
August 2020	-4.1	-10.3	-5.2	0.4	0.8	5.9	1.3	2.0	7.2
Sources: IPF, Capital Economics									

However, improvements in 2020 were balanced by downgrades to next year's forecast. The consensus forecast from IPF shows overall property capital values falling by a further 2% next year, compared with the small rise predicted in the previous survey. This in part reflects weaker rental prospects in both office and retail sectors. While Capital Economics also revised down their all-property forecasts, they still expect that there will be a slight rise in values as the UK economy recovers in 2021.

From a low of -8.1% last quarter, the 2020 total return forecast has increased by almost 80 bps as the rate of capital value decline now anticipated in the current year has moderated, while the implied income return has risen slightly. Over the last quarter, a negative outlook for capital values in 2021 and lower projected growth rate in 2022 have forced the next two years' total return forecasts down – by 200 bps in 2021 and almost 70 bps in 2022 (from 0.2% and 7.9% respectively). Although predicted returns in the final two years have risen, these improvements are insufficient to sustain the five-year average, which has fallen by over 40 bps (from -1.3% pa).

Chart A: All Property total return forecasts



Source: IPF Survey of Independent Forecasts for UK Commercial Property Investment

It should be noted that while the capital values and total returns from the table are in line with the chart, the rental value forecast and income return expectations cannot be compared like for like. For instance, in 2021 the IPF forecast is that we may see a drop in rental value at 1.9% and this will certainly have an impact on income returns especially when the current leases and rent arrangements come to an end and new rents are negotiated. However, property funds are benefiting from long term arrangement and leases, when rent value is agreed and not open to frequent re-negotiations. Therefore, even if a rental value declines 1.9% during 2021, this does not mean that the income return that these funds provide will drop by a whole 1.9% as funds will be charging their tenants fixed rates over a fixed period of time. Consequently, a large portion of aggregate rental income that these funds will generate during 2021 will not be affected by a full drop in rental value until new rental arrangements are up for individual renegotiation between funds and their tenants and that, the forecast provided in the chart implies income returns are fairly stable.

Further detail on the performance experienced is shown in **Appendix 1**. We do not yet know the full impact on real estate markets from COVID-19 and we continue to learn more every day. While we will have to bear the brunt of the after effects of the lockdown in terms of reduced economic activity, we are seeing signs of recovery and resilience in certain parts of the economy, and consequently the Funds real estate portfolio. For most funds, the strategic position, resilient tenant base and the Fund Management Teams' efforts, has maximised rent collection during this challenging period.

Being able to report relatively high collection rates (approaching 80%) for both the March and June payment dates is positive. The Quarter 2 results are due at the time of writing and can be updated at the meeting.

Conclusions

While risk is inherent in investment decisions, property fund investments provide investors with a strong level of return over the medium to longer term investment time horizon – which is why the Council was clear at the outset that the investments would be longer term (at least 10 years) in order to benefit from capital growth and generating significantly improved annual investment returns supporting the revenue budget. The overall return is made up of income, achieved via rental streams and capital via the changing value of underlying properties within a fund. While the second element is the most volatile from a year-to-year perspective, the income produced by the funds is relatively stable.

It is clear that it will be many months before the impact of the pandemic on the wider economy and the associated impact on real estate markets is known, however, we are seeing signs of recovery and resilience in certain parts of the economy, and consequently the Funds real estate portfolio. Most funds are able to report relatively high collection rates (approaching 80%) for both the March and June payment dates which is positive – however, the effects of the furlough scheme measures ending and a second wave over the coming months could seriously impact the wider economy and real estate markets.

It is therefore suggested that planned investments be deferred with a review during Spring 2021, when the situation should be clearer, to inform future investment plans.

Background

Utilising the capital receipt proceeds of the sale of the Golf Course, a capital budget of £12m was approved in 2018/19 for long-term investment in a number of property funds, following a Property Fund Manager selection exercise, supported by Link Asset Services who provided support and advice in the identification and selection of suitable UK-focused property funds. The aim was to generate improved returns of c.4 to 5% p.a. (plus asset growth) from investments in a diversified Property Fund – these being long term investments of between 5 to 10 years (minimum) in order to make the necessary returns (after set up costs).

All Members were invited to be involved in the discussions, with a Treasury Management briefing session (including a Property Fund Selection Briefing) held on 21st February 2018 and Members of the Full Council, on 27th February 2018, endorsing the approach taken in the selection of Property Funds and approving investment in those property funds. It should be noted that from the outset, the Council was looking to engage with funds that had a broad remit of exposures to different property types (such as offices, industrial, retail warehousing etc. – as detailed in table 3), rather than being focussed on one particular area, such as shopping centres.

Table 4: Property Type Diversification

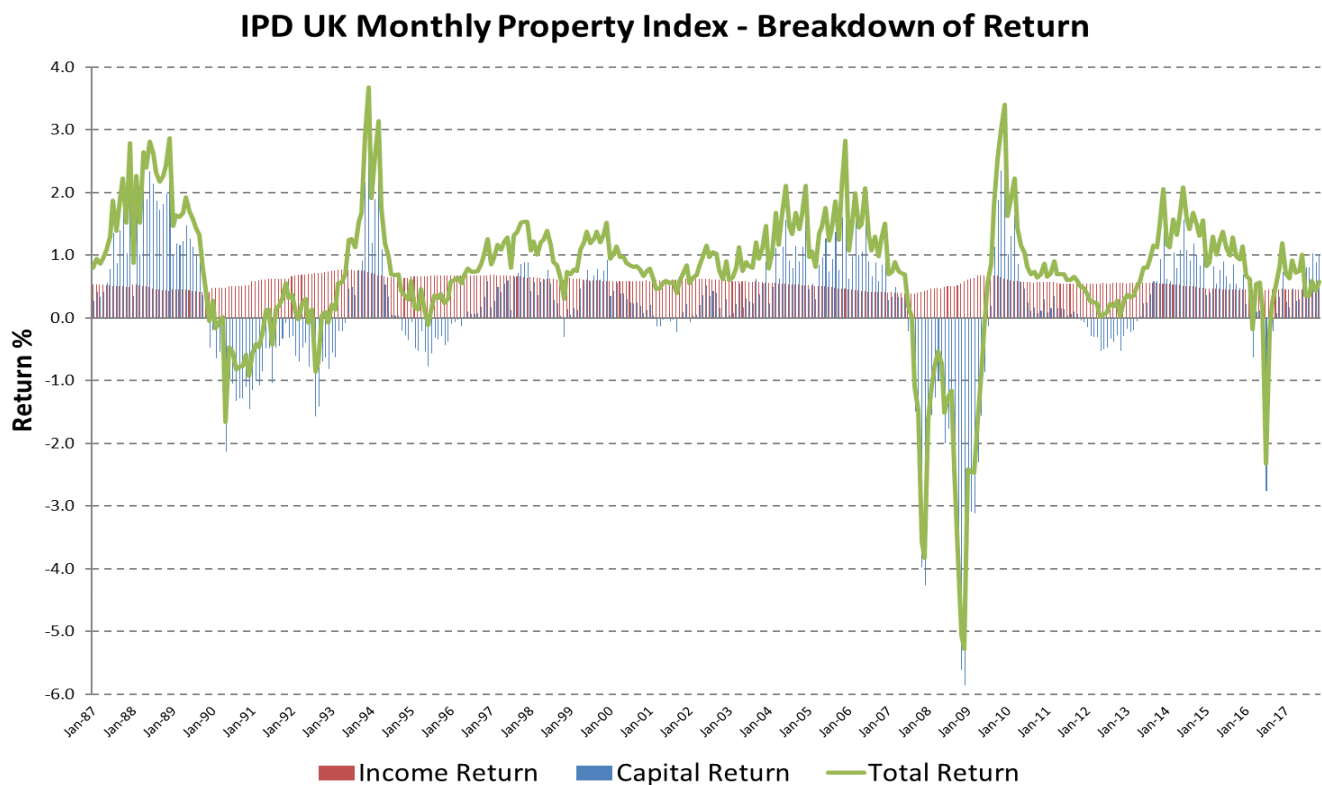
	The Local Authorities' Property Fund (CCLA)	Lothbury Property Trust	Hermes Property Unit Trust	BlackRock UK Property Fund	Schroders UK Real Estate Fund	Threadneedle Property Unit Trust
Revenue/Capital	Revenue	Revenue	Revenue	Capital	Capital	Capital
	%	%	%	%	%	%
Sector Diversification:						
Industrial %	34.1	17.1	25.2	27.3	21.1	26.7
Offices %	40.5	26.4	40.2	26.4	41	33.8
Shopping Centres %	0	8.1	2.7	5.6	4.9	0.5
Retail Warehouse %	18.3	12.8	11.6	19.5	8.6	18.2
Retail %	6.1	27.8	8.8	3.8	11.9	13.7
Other %	0.9	8	11.7	17.5	12.6	7.2
Total	100	100	100	100	100	100

Source: Direct fund data, December 2017

To date, the Council has invested £1.85m with Schroders UK Real Estate Fund and £2m with Threadneedle Property Unit Trust, total investment £3.85m – however, capital values have fallen by £291k since, mainly since 31st March 2020 (£163k).

It should also be noted that investments in property are subject to fluctuations in value over the economic cycle and should also yield capital growth in the longer term as the economy grows. However, it should also be noted that dividend yields have been consistent which means the investment returns, over and above the usual money market levels, can be used to support the revenue budget – as demonstrated in the Property index chart 1.

Chart B: Property Funds – Return Split Percentages



Source: Bloomberg. Index data from Jan 1987 – Nov 2017 showing split of returns.

Link Asset Services looked to the “Balanced Fund” universe of UK property funds, as outlined in the AREF/IPD UK Quarterly Property Fund Index, for the starting point for selection. This universe is the industry accepted standard for balanced property funds and included 27 funds as at the close of September 2017.

From this initial list, a number of funds were removed in instances where the Council would not be able to invest, for example those that are solely for pension funds and others where investor types are limited, excluding Local Authorities. The Council also looked to exclude funds below a minimum size threshold of £750m. This left 10 funds from which to further shortlist, and each was sent a copy of a questionnaire to complete, which had been drawn up in conjunction with Link Asset Services and focussed on a number of key areas. Following consideration of the completed questionnaires, a shortlist of 6 funds was drawn up, and the Fund Managers were invited to attend the Council’s offices and give a presentation on their fund and answer questions from the selection panel, which consisted of Council officers and Link Asset Services. Further details of the selection process are included in Link Asset Services’ report presented to Members 21st February 2018 and included within background papers to this report.

The result of the process was to look to consider splitting investment across the following six funds:-

- BlackRock UK Property Fund
- Hermes Property Unit Trust
- Lothbury Property Trust
- Schroder UK Real Estate Fund
- The Local Authorities Property Fund (CCLA)
- Threadneedle Property Unit Trust

This provides the Council with a range of approaches to property fund investment, diversification across a number of funds, rather than a concentration in only one or two options, as well as the ability to take advantage of entering a number of funds via the secondary market, whereby the Council would be purchasing units from investors looking to exit the particular fund, and may potentially gain access to a fund at a lower level of cost than via the primary route.

Equalities implications

There are no equalities implications arising from the report.

Legal implications

The Council is able to invest in property funds under legislation contained within the Local Government Act 2003.

Resource and Value for Money implications

The MTFS includes budgeted income of £300k for 2020/21 (£480k pa from 2021/22) arising from investment of the full £12m budgeted, however, due to uncertainty around arrangements for Brexit and the associated impact on the economy, and then the further uncertainty and questions over the potential outlook for future property fund returns as a result of the coronavirus, any further investment in property funds had been delayed until there is more clarity. This will mean that the planned returns will have to be deferred with a consequential impact on the MTFS forecast.

Risk implications

Risk is inherent in Treasury Management and as such a risk based approach has been adopted throughout the report with regard to Treasury Management processes.

Report Author

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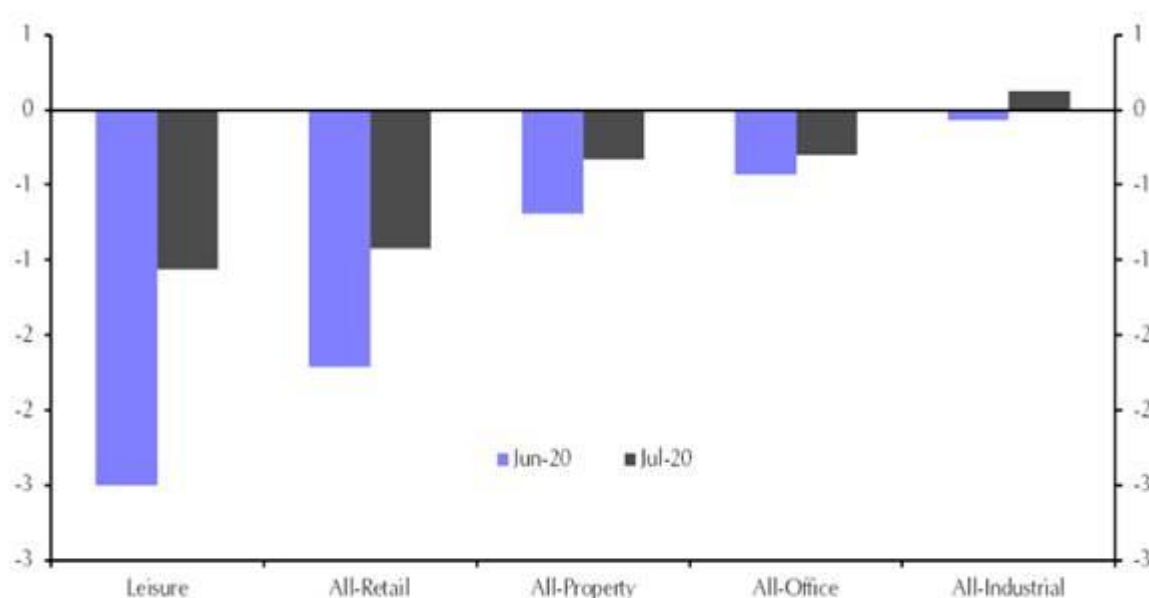
<i>Background Papers:-</i>	<i>IPF Summer 2020 Survey of Independent Forecasts for UK Commercial Property Investment</i> https://www.ipf.org.uk/resourceLibrary/ipf-uk-consensus-forecasts--summer-2020--full-report.html
	<i>Corporate Vision, Priorities Plan, Budget & Medium Term Financial Strategy 2018/19 Including Treasury Management Strategy Statement, Minimum Revenue Provision Policy Statement and Annual Investment Statement 2018/19, Council 27th February 2018</i>
	Link Asset Services Treasury Management Training including Property Fund Selection Briefing for Members 21 st February 2018
	Link Asset Services Property Fund Selection Report December 2017

Property Fund Performance 2020

At an all-property level, rental values fell at a slower pace in July than June, from minus 0.2% m/m, from minus 0.4% m/m. Although there was a notable slowing in retail rental declines, retail still drove the decline in all-property rents. Furthermore, forecasters expect more pain ahead. This is in-line with the Royal Institute of Chartered Surveyors (RICS) survey, which showed that expectations for retail rental values over the next 12 months worsened.

Equivalent yields showed signs of stabilising in July, increasing by just 1bp. In turn, capital values fell by just 0.3% m/m in July, which was slower than the 0.7% m/m decline in the previous month (chart 1 below). If yield rises resume later this year, as Capital Economics anticipate, this will indicate a further decline in capital values. Annual returns were broadly unchanged in July, at minus 2.8%, but further falls in capital values would evidently see them worsen.

Chart 1: Capital Values by Sector (% m/m)



Source: MSCI

All-property equivalent yields barely rose in July, improving by just 1bps. This followed a small 2bps increase in June. Although this implies that pricing may have fully adjusted, Capital Economics expect further yield rises in the second half of this year. At a sector level, industrial yields were unchanged in July, and office and retail yields rose by 2bps and 3bps m/m respectively. Despite government support, investors remain cautious about leisure assets, where yields rose 9bps m/m in July and have now increased by 105bps since January.

Chart 2: Equivalent Yields by Sector

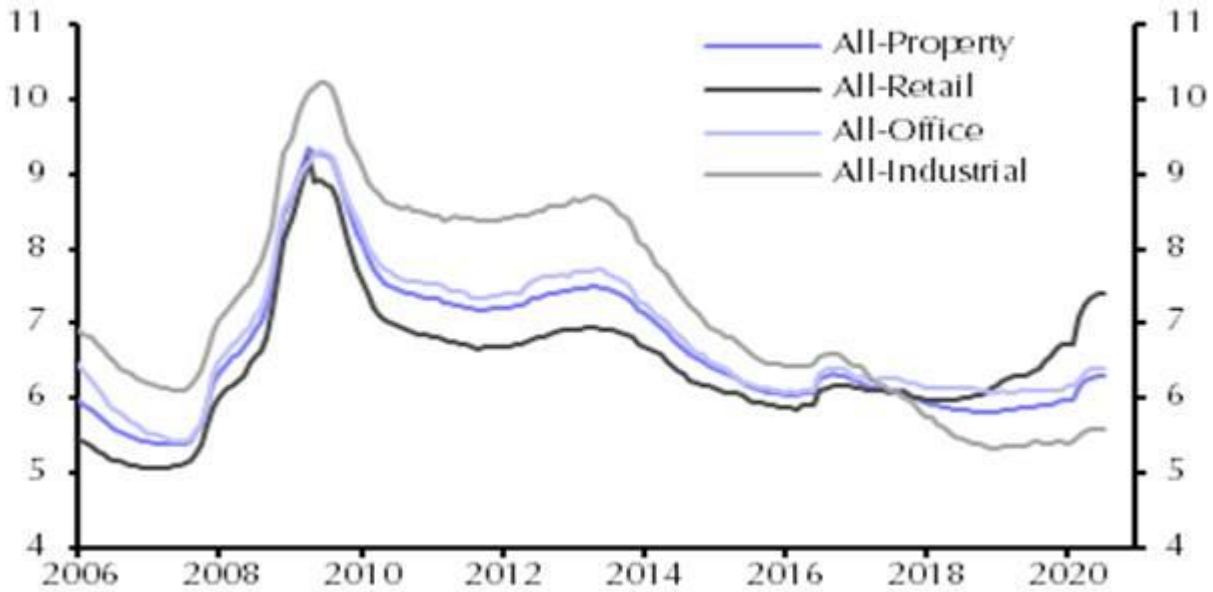
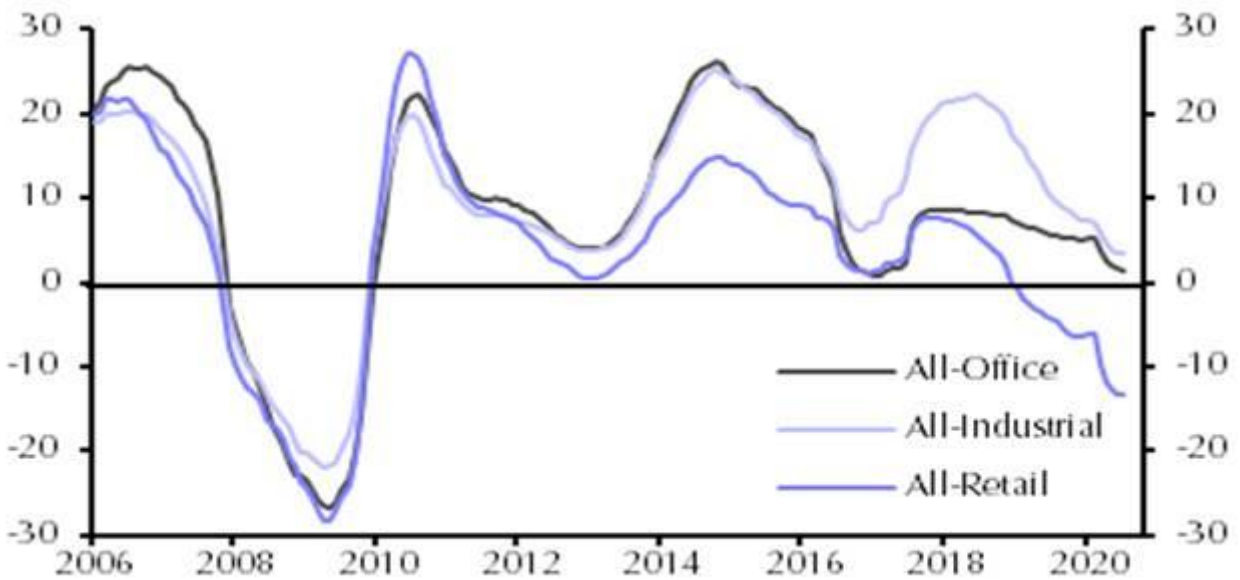


Chart 3: Total return by sector Year on Year



From a low of -8.1% last quarter, the 2020 total return forecast has increased by almost 80 bps as the rate of capital value decline now anticipated in the current year has moderated, while the implied income return has risen slightly. Over the last quarter, a negative outlook for capital values in 2021 and lower projected growth rate in 2022 have forced the next two years' total return forecasts down – by 200 bps in 2021 and almost 70 bps in 2022 (from 0.2% and 7.9% respectively). Although predicted returns in the final two years have risen, these improvements are insufficient to sustain the five-year average, which has fallen by over 40 bps (from -1.3% pa).