LGPS Pooling: The Ten Billion Pound Indirect Question

According to the "Findings of Project Pool", a report which has formed the basis of discussion between the Local Government Pension Schemes (LGPS) and the Government on the best way forward with the asset pooling initiative, the greatest savings from real estate pooling will arise from the migration from indirect to direct ownership. According to research by DTZ Investors, LGPS pools (Pools) hold over £10bn of the AREF/IPD UK Quarterly Property Fund Index (IPD PFI), equating to more than 20% of the Index by value.

If a high proportion of LGPS investors look to liquidate their holdings at the same time, the impact on the UK property market would be significant. In this snapshot, we outline the findings of our research in this area; the implications this could have on the UK property market; why we think addressing the issue now should benefit all parties; and its possible impact on the future of the unlisted property fund market.

Background

Pools are being encouraged to only use indirect property investments to gain exposure to specialist sectors and/or overseas investments and may therefore look to realise current holdings in traditional sector and core/balanced property funds. It is argued that exposure to the traditional UK property sectors should be secured collectively via direct segregated accounts, which should result in cost savings as managers will be prepared to offer reduced fees in return for managing larger allocations.

Our research

DTZ Investors has used its extensive range of contacts in the UK unlisted property fund management industry to pull together an analysis of the level of exposure to LGPS investors of the funds listed in the IPD PFI. The Net Asset Value (NAV) of the IPD PFI as at year-end 2017 equated to approximately £50bn. Although a number of managers were unable to provide exact figures, most fund managers were able to provide percentage holdings within their funds on an approximate basis as at the end of 2017.

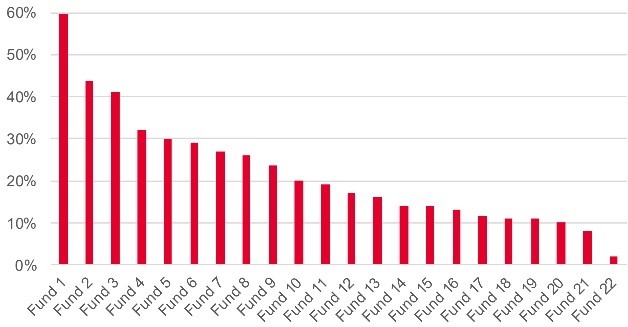
Our findings

Having analysed nearly two-thirds (by value) of the UK unlisted property fund market contained within the IPD PFI, we have calculated that over 20% of this is held by LGPS investors. Extrapolating these results suggests that **the Pools own almost £11bn of UK unlisted property fund exposure**.

However, of greater interest, is how heavily invested the Pools are into UK balanced property funds, holding more than 25% of this sub-fund market. Significant LGPS ownership could be a warning to both managers and investors alike given that the diversified sector strategies of these funds provide precisely the type of real estate exposure that LGPS are being encouraged to create themselves directly. In our opinion, it is the balanced UK property funds which are at greatest risk of witnessing significant outflows.

The chart below shows the exposure to LGPS investors of the funds we contacted: five had 30% or more exposure to LGPS clients; three had more than 40%; and one had c. 60% exposure.

Figure 1: Exposure to LGPS investors



The implications

Given the requirement to access the traditional sectors of the UK property market directly, our analysis suggests that there could be in the region of £8bn of balanced fund holdings which may need to be realised (either sold or redeemed) by LGPS investors.

Moreover, we estimate that there was £1.0bn of broker-led transactions in the UK secondary market in 2017, consistent with annual activity over the two to three years prior to this. This would indicate that if the secondary market were the only exit option, **it would take over 8 years for LGPS investors to liquidate their balanced fund positions.**

Furthermore, with some fund managers having very high proportions of their funds held by LGPS clients, a number of these funds may no longer be viable, which could ultimately result in **further consolidation in the UK unlisted property fund market and therefore less choice for the investor, unless capital can be raised from other sources.**

*DTZ Investors estimates that LGPS clients hold **approximately 20%**, equating to **over £10bn**, of UK unlisted property fund exposure*

This all points towards a looming illiquidity crisis in the unlisted fund market once the Pools do turn their attention to pooling their real estate assets, and a contagion effect could take hold in their rush to the exits.

Our recommendations

Unlike other historical events that have prompted illiquidity in the market, the industry has a long and well signposted lead-in time in which to acknowledge the issue and come up with a solution. **We believe the Pools will need to work together in order to achieve this ahead of time**.

Overseas investors would be one possible replacement source of capital but with non-residents becoming liable to pay capital gains tax on UK property interests from April 2019, there is likely to be less appetite here, particularly given the uncertain Brexit environment.

If replacement capital cannot be found, certain Pools could look to take funds 'in-house', acquiring the units it doesn't currently own to take 100% ownership and effect direct exposure that way. Alternatively, the Pools could take in-specie transfers of an asset (or assets) from a fund rather than realise cash proceeds to again arrive at the desired outcome of direct property exposure. However, in-specie transfers are notoriously difficult to manage. It is not possible to simply cherry pick the best assets; there is a potential conflict of interest with regards to which assets exiting investors inherit and which assets remaining investors retain exposure to; and finally, to our knowledge, there is very little precedent in this regard.

The options we have outlined above will clearly not be viable for many of the funds involved and, therefore, both the Pools and funds need to acknowledge now what the long term position of LGPS investors are and map out a medium term disposal programme of the underlying portfolios to prevent a rush to the exits and an illiquidity lock up. If all parties come together to discuss possible remedies now, the 'perfect storm' of a raft of redemption requests in the medium term, coming at what may well be a time of both a market correction and Brexit finally coming to pass, could be avoided.

In light of the various headwinds, as well as the nuances of the unlisted property fund market, **Pools should be looking for the support and advice of managers experienced in this area of the real estate market,** with a long term track record of successfully transitioning portfolios.

The future of the unlisted property fund market

While this might all sound like the death knell for LGPS investment into unlisted property funds, we do not believe this will be the case.

Inevitably, we expect there will be further consolidation in the unlisted market, particularly for the balanced funds. However, in line with one of the main recommendations from the Project Pool report, there is likely to be continued, or possibly increased, demand for exposure to the specialist fund space, and we hope that new funds and strategies will come to the fore as a result.

There is also likely to be an increased demand for viable unlisted property fund investment opportunities overseas as the Pools look to diversify their exposure outside the UK.

Here at DTZ Investors, as well as being experienced 'transition managers' from indirect to direct property portfolios, we have long advocated the use of indirect vehicles to secure exposure to the specialist sectors of the property market, and this is a strategy which we have employed for our clients, including local authorities, over the past 20 years.

We believe it makes sense to invest into the specialist sub-sectors of the property market indirectly where exposure cannot be secured directly; where sufficient diversification within a sub-sector is not possible to achieve directly; to reduce the reputational risk of investing in certain sub-sectors of the market directly; or to venture overseas.

About DTZ Investors

DTZ Investors is a specialist European Real Estate Fund Manager, part of the Cushman & Wakefield Group. The business was established in 1968 in the UK and expanded into Continental Europe in 1999. At DTZ Investors, our indirect investment team has a range of complementary skills and a wealth of experience in managing successful indirect investment mandates. Our strategies are supported by our in-house strategy team and Cushman & Wakefield's global research capability, C&W Research (which covers over 220 international markets). We offer a full indirect fund management service which can be tailored to meet client needs. Portfolios are managed separately, not collectively, with each portfolio structured according to clients' individual objectives and requirements.

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