AGENDA ITEM: 6 Page nos. 1 - 22

Meeting	Pension Fund Committee
Date	15 March 2012
Subject	**Presentation on Co-investment in Residential Housing**
Report of	Deputy Chief Executive
Summary	A presentation will be given to the Committee on co-investment in residential housing by the Mill Group. The presentation will outline the structure of the product, set up costs and forecast investment returns

Officer Contributors	John Hooton, Assistant Director of Strategic Finance Iain Millar, Head of Treasury and Pensions
Status (public or exempt)	Public
Wards affected	None
Key Decision	Not Applicable
For decision by	Pension Fund Committee
Function of	Council
Enclosures	Investors in Housing - Draft

Contact for further information: Iain Millar Head of Treasury and Pensions Tel: 0208 359 7126

RECOMMENDATIONS

1.1 That the Committee note the content of the presentation to be provided to the Committee.

2. RELEVANT PREVIOUS DECISIONS

2.1 On 20th December 2011, Pension Fund Committee considered the options making an allocation to complimentary classes including institutional investment into residential housing. The Committee requested that a fund manager presentation on institutional investment in residential housing be arranged for its next meeting.

3. CORPORATE PRIORITIES AND POLICY CONSIDERATIONS

3.1 Consideration of the use of alternative asset classes to further diversify the Pension Fund investment strategy supports the corporate priority of getting the best value from our resources.

4. RISK MANAGEMENT ISSUES

4.1 The ongoing viability of the Pension Fund is dependent on maximising investment income with due regard to the risk returns of the investment vehicles used

5. EQUALITIES AND DIVERSITY ISSUES

5.1 Ensuring the long term financial health of the pension fund will benefit everyone who contributes to it.

6. USE OF RESOURCES IMPLICATIONS (Finance, Procurement, Performance & Value for Money, Staffing, IT, Property, Sustainability)

6.1 This report is just for information; there are no procurement, performance & value for money, staffing, IT, Property or Sustainability implications.

7. LEGAL ISSUES

7.1 No specific legal issues, this report is just for information.

8. CONSTITUTIONAL POWERS

8.1 Constitution – Part 3 Responsibility for Functions – Section 2 – Responsibility for Council Functions delegated to the Pension Fund Committee through the Pension Fund Governance Compliance Statement.

9. BACKGROUND INFORMATION

9.1 The Pension Fund Committee requested more information on the option to invest in residential housing through a fund manager presentation to the Pension Fund

Committee, following consideration of an allocation to complimentary asset classes on 20th December 2011.

10. LIST OF BACKGROUND PAPERS

10.1 None.

Legal: SWS
CFO: JH

Investors in Housing

Draft

BARNET
LONDON BOROUGH

March 2012
Presentation by
Simon Phillips

MILL GROUP

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    - a person for whom an FSA authorised firm of which the person is a client has taken reasonable steps to ensure that investment in the scheme is suitable,
    - a person whom an FSA authorised firm has assessed as capable of making his own investment decisions and understanding the risks involved.

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Introduction

This presentation will demonstrate why investing in residential property through Investors in Housing can generate strong income returns and above average capital growth for the Barnet Pension Fund:

- **Why residential property?**
- **Why London residential property?**
- **Why Co-investment?**
- **How does Co-investment work?**
- **What returns can Co-investment generate for the investor?**
- **How can this opportunity be structured?**

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Where does the Investors in Housing proposition fit?

➔ **CLIENT INVESTMENT OPTIONS**

- ▪ EQUITIES
- ▪ GILTS / BONDS
- ▪ ALTERNATIVES
- ✓ PROPERTY
  - ▪ OFFICES
  - ▪ RETAIL
  - ▪ INDUSTRIAL
  - ✓ OTHER
    - ▪ LEISURE
    - ▪ HOTELS
    - ▪ STUDENT ACCOMODATION
    - ▪ INFRASTRUCTURE
    - ✓ RESIDENTIAL
      - ▪ PRIME
      - ▪ PRIVATE RENTAL
      - ▪ SOCIAL
      - ✓ INVESTORS IN HOUSING
        - ✓ Upfront Risk Transferred to Mill Group
        - ✓ Varied Portfolio
        - ✓ Spread of Risk
        - ✓ Greater Rates of Return
        - ✓ Larger Availability of Stock
        - ✓ Stronger Residual Values
        - ✓ Diverse Range of Exit Options
        - ✓ Longer Dated Income

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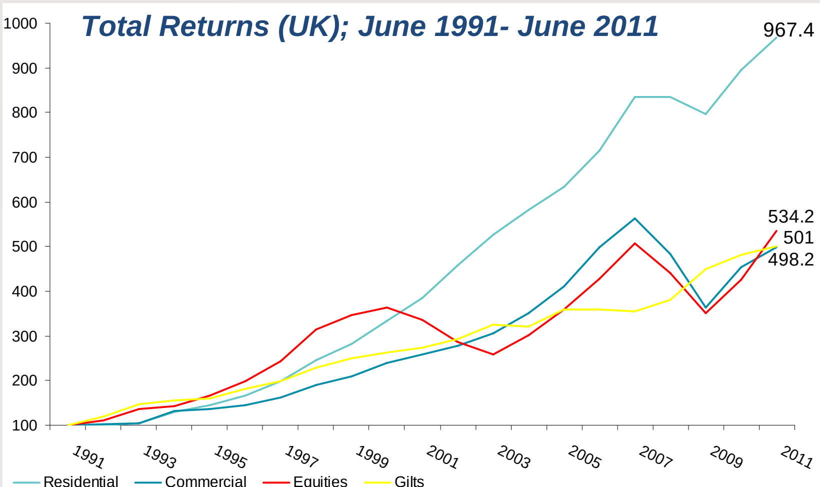
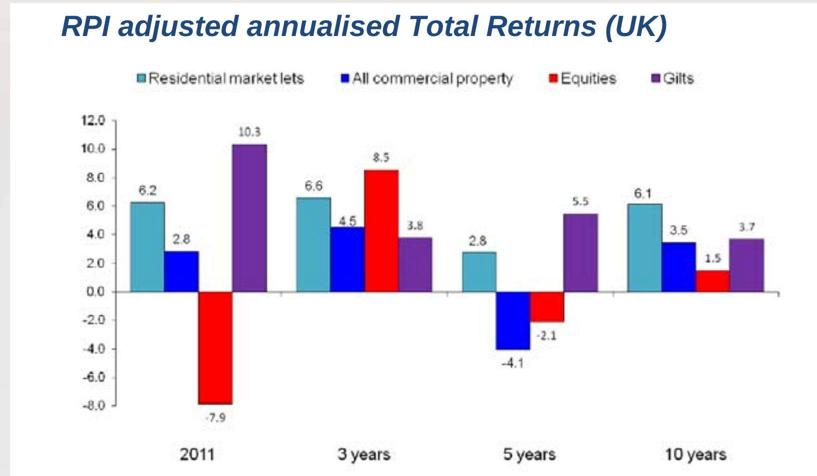
How has the residential asset class performed compared to others?

UK residential property has historically proved to be a more attractive asset class as compared to commercial real estate, equities and gilts



Source: IPD Sep 2011



Source: IPD Feb 2012

- An investment in the UK residential sector in 1991 would have resulted in a c.10 times total return over a 20 year period; nearly twice as much as other asset classes.

- Good investment in an inflationary environment
- Outperformed other asset classes in real terms over 5 and 10 years

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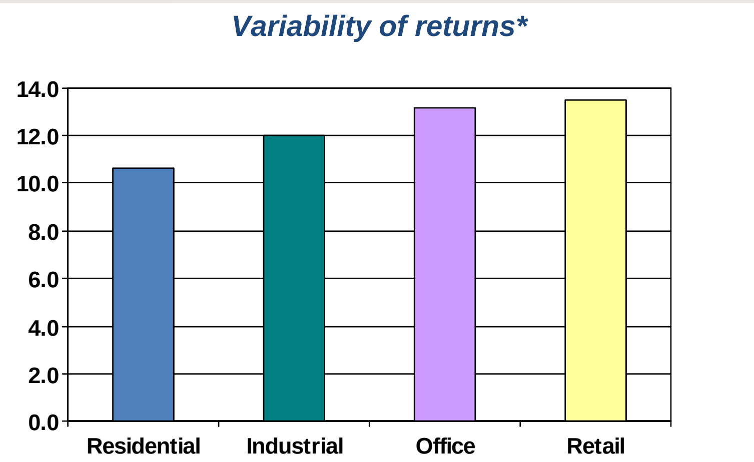
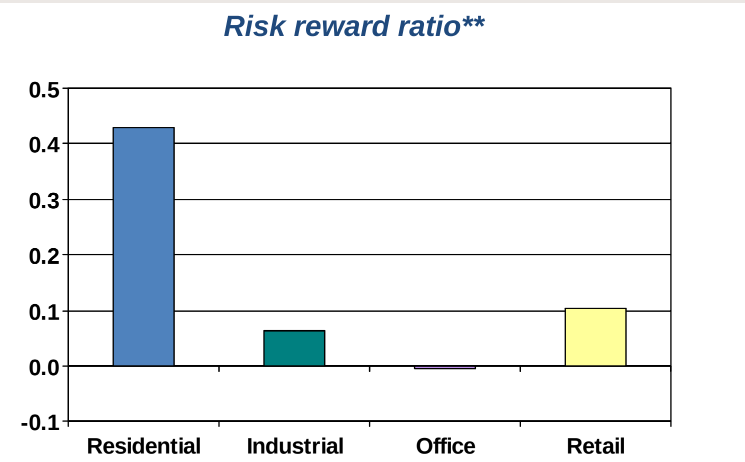
Comparative performance of real estate asset classes

UK residential property has historically delivered more stable and predictable returns which offer a better risk reward ratio



Source: IPD July 2011



Source: IPD July 2011

- An investment in the UK residential sector between 2000 and 2010 resulted in a lower volatility of returns compared to other real estate asset classes by between 20% - 30% over the same period

- An investment in the UK residential sector between 2000 and 2010 delivered a much better risk/ reward ratio than other real estate class over the same period

*Standard deviation

** Sharpe ratio

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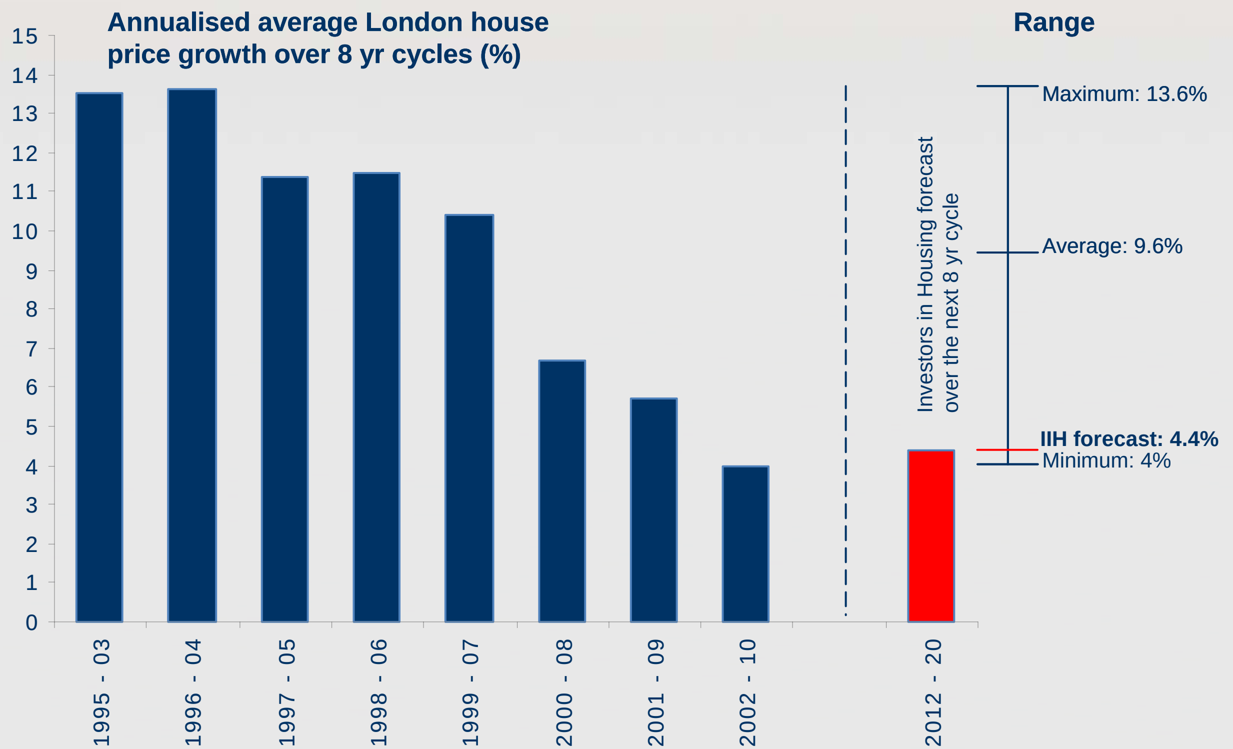
London property prices remained stable during the crisis

The minimum average growth in London house prices has been 4% p.a. with the average being 9.6% - over any 8 year period during which Land Registry has collated house price data.



Source: Land Registry

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London house prices will remain strong in the future

The demand for London property is anticipated to outstrip supply, putting continued upwards pressure on property prices

- **Demand**
  - Changing household formation & net immigration
  - London is an economic hub & has lower unemployment levels
  - London has higher average earnings & is Internationally attractive
  - **Lack of finance is frustrating this demand, as are concerns of negative equity**
  - **There is high demand for an alternative solution**

In 2011, over 1 million + aspiring first time buyers were unable to buy a home. Their average age is 37.

- **Supply**
  - Lack of new housing – a current shortfall of 50%*
  - Severe planning limitations
  - Lack of consumer finance due to debt drought
  - Rental market on the rise = less homes for sale

In 2011, only 120,000 new properties were built in UK, the lowest level since 1920's.

*This is the shortfall between the number of properties required based on household growth and the new housing required to ensure there is no shortfall – Savills Budget Commentary 03/11

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Investment Strategy in Residential – the smarter way

Generate higher returns via expert property selection and higher yields by replacing tenants with “part owners/long-term occupiers”

Investment return

Capital growth

Income

- Very large stock from which to ‘cherry-pick’ for the portfolio
- Highly scalable
- London focus/desirable locations
- Properties matched to occupier demographics, infrastructure and amenities
- Lower risk, with development optional

Part owners/long-term occupiers

- Willing to pay premium to rents
- Willing to take on repair and maintenance responsibilities
- Wanting occupancy on longer terms
- Are individually selected and assessed

The smarter way to buy a home – for investor and consumer

Mill Group's unique 'Co-investment model' has been designed to enhance gross income and protect net income yield, reduce risk and avoid costly void periods

At acquisition

A simple joint venture through which an investor and a prime consumer (with a minimum 5%) will jointly acquire 100% of a desirable property without debt

5% OMV*

(Up to 15%)

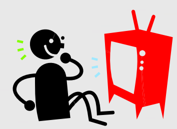
95% OMV

Acquisition costs

Investor

During Co-investment period

In return for sole occupation, the consumer pays an occupation charge to the investor and is responsible for the maintenance, insurance and other service charges for the property



7% occupation charge on investor's share

Investor

- RPI upward only increase each year for five years
- Repair/maintenance/insurance etc costs payable by consumer
- 5 yearly rebasing of occupation charge, upward only, to 7% of open market value share

* Open Market Value also referred to as vacant possession value

Residential investment with a number of exit options

1. **Individual properties may be sold to the consumer – exit at 95% OMV**
   - Incentive offer to consumer at 5% discount in yr 6&7 – ie buy Investor's 95% share at 90% (efficient sale since it eliminates estate agents fees, voids and other costs of selling)
   - Opportunity for consumer to buy out the investor interest in the property at OMV – option available from year 3
   - Better net return than portfolio sale, thus improving IRRs

2. **If the co-owner wishes to move on without purchasing – exit at full OMV** net of costs
   - Full value sale without discount; or
     - Establish new Co-investment arrangement; or
     - Rent the property

3. **Sale of property portfolio**
   - Base case model assumes sale achievable at 90% of OMV; under control of investor - simple and clean
   - Portfolios should be saleable to the same market as other investment portfolios

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Co-investment – a product for now

FOR CONSUMER: 5% - 15% SHARE OF PROPERTY: With a good income, but without a 20% deposit, Co-investment is the only solution for people who want out of the rental market. It offers a secure, long term tenure, fixed real term costs, no risk of negative equity, and the opportunity to buy the home of their choice when they are ready.

FOR INVESTOR: 85% - 95% SHARE OF PROPERTY: A quality occupier committed to caring for the property. It provides long term income incurring minimal costs or voids. It offers a unique exit with the co-owner wanting to buy out the investor.

	Renting	*Co-investment*	*Buying with a mortgage*
Security of tenure/ need to move	Initial term only – involuntary move with little notice	Secure – no need to move	Secure – no need to move
Personalise a home	No	Yes	Yes
Future monthly cost	Uncontrollable	RPI only for 5 years	Interest rate dependant
Repair costs	Landlord	Consumer	Consumer
Insurance	Landlord	Consumer	Consumer
Benefit from house price growth	No	Yes	Yes
Minimum Deposit requirements	1-3 Months	5 %	10-20 %
Negative equity risk	No	No	Yes

Why is Co-investment attractive to a consumer?

The Co-investment model is designed to attract those FTBs who are currently renting and want to step onto the housing ladder. They have an above average salary but do not have the high deposit required for a mortgage.

Typical Co-owner

Reality of renting

Dead money

No security of tenure (have to move regularly)

No sense of ownership

No opportunity to build credit rating

- All unlike co-investment

How does a 7% co-investment charge compare to rent & mortgage?

Co-investment compares favourably when compared to the repayment cost of renting a similar property and the cost of a 90% repayment mortgage

Current rental yields*	Rental range	5 - 7%	
Mortgage cost comparator**	Interest rate	5.8%	
	Servicing cost	7.6%	cost of mortgage pa as % of mortgage
Co-investment	Charge	7.0%	Paid on investor share of property
	Nominal Yield	6.6%	occupancy charge as a % of property value

*Based on average asking rents for 2,000 properties and average asking sale prices of 3,000 properties in Barnet as featured on www.zoopla.co.uk and www.Londonpropertwatch.com- Feb 2011.

**As at Feb 2011 average 90% mortgage servicing cost for 5 yr fixed deals available to FTBs from high st lenders .

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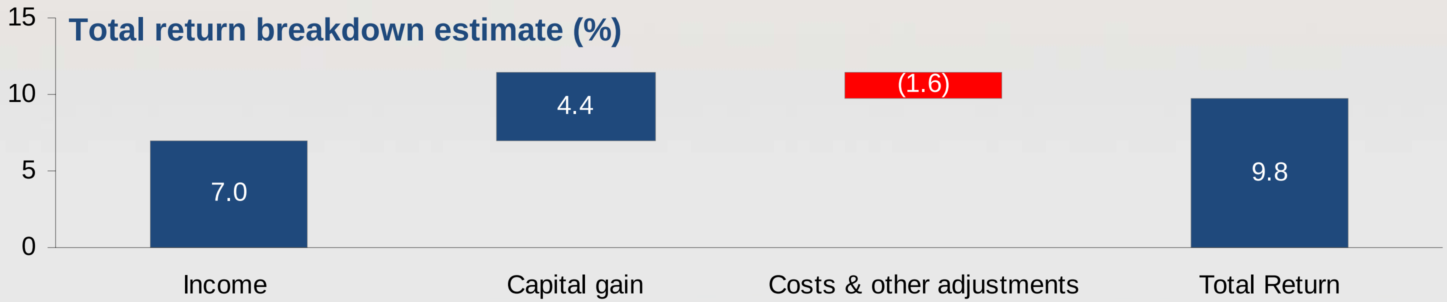
What returns should investors expect?

Due to the high levels of income being generated and the exposure to London residential properties (benefitting from strong demand and constrained supply); a 6.7% annualised distribution and a 9.8% IRR is anticipated



6.7% pa[1] distributions

Strong demand + Constrained supply

9.8% IRR[1]

Mill Group's house price inflation (HPI) forecast[2]

HPI % growth forecast	*2012*	*2013*	*2014*	*2015*	*2016*	*2017*	*2018*	*2019*	*8 Yr Compound Annualised Average*
London	-0.1	0.9	4.6	6.4	6.0	5.5	5.7	6.3	4.4

1. Anticipated based on key modelling assumptions; distributions from year 2 onwards as year 1 cash reinvested (average distribution figure for years 2-5 quoted)
2. In-house estimation based on external research forecasts with an asset selection premium

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In summary…

The Investors in Housing proposition has been designed to provide Barnet with attractive, long-dated RPI linked income, stable returns, via good quality assets which are managed professionally

- Benefits to the LB Barnet Pension Fund
  - Exposure to an attractive asset class
    - Strong historic performance of UK/London residential property
    - Good future prospects for London residential property
  - Attractive anticipated investment returns
    - Upwards only RPI linked income
    - Attractive gross-to-net yields
    - Similar benefits to commercial FRI* arrangements
    - Diversified asset base
    - Robust covenant from multiple credit checked consumers
    - Scalability
  - Flexible, efficient & anonymity providing structure
    - Simple, effective arrangement
    - Investor identity protected via nominee legal structure

*Full Repairing and Insurance (FRI) - Where the occupier has full repairing and insuring obligations

How will the investment be structured?

An tax transparent, flexible, Limited Partnership structure will be used

FUND KEY TERMS

Legal form:	English Limited Partnership
Minimum investment:	£10m
Commitment period of the fund:	Two years
Term:	Nine years
Investment period:	Initial two years, capital proceeds may be reinvested
Borrowings:	30% (may be increased to 50% with investor consent)
Total Expense Ratio*:	0.95% of Gross Asset Value
Carry:	20% above a 10% hurdle
Investor participation:	Investor Advisory Committee with veto rights

** Anticipated during steady state period; equivalent to 1.3% of Net Asset Value*

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What is the fee structure?

	FUND FEES AND COSTS*	
Set-up	Fund Set-up:	£475k**
	Anticipated Investor DD costs:	£100k
Core period	Asset Management :	0.85% of NAV p.a.
	Property transactional costs:	£8.5k per acquisition; Stamp Duty; Valuation/Legals
	Operator fee:	£150k
	Finance arrangement fee:	1.5% of facility
	Anticipated fund running costs:	£100k p.a.
	Anticipated fund valuation cost:	£50k p.a.
Exit	Property disposal fee:	1% of sale proceeds; Legal/Agent costs
	Fund wind up fee:	0.25% net sale proceeds

**Excluding VAT;*

***Subject to confirmation*

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