

Pension Fund Committee

Meeting to be held on 7 June 2013

Electoral Division affected: All

Strategy for the Procurement of UK and Local Property Investment Managers and Independent Valuers

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Executive Summary

The Fund has an existing UK property portfolio (currently £434m) and has allocated 3% of the Fund value (around £150m) to building a Local property portfolio in the County of Lancashire. While aspects of the contracts for the management and independent valuation of the Fund's UK property portfolio have been renegotiated to the advantage of the Fund and a temporary arrangement has been entered into for the Local portfolio, the contracts have not been fully tendered for many years. At the same time as seeking an investment manager for the Local portfolio, it is proposed to fully market test the UK portfolio investment management contract and the contract for the Independent Valuer

Recommendation

The Committee is asked to approve the procurement strategy for the appointment of the UK and Local property investment management mandate and independent valuation contracts as set out in the report.

Background and Advice

As shown in the Fund Performance Report, the Fund's investments are allocated across three main categories: equities, property and lower volatility strategies. The property allocation supports the Fund's objectives through both providing rental income and also through an appreciation of the capital value of the properties.

The Fund has two property portfolios, a UK property portfolio and a Local property portfolio. The UK property portfolio is a balanced portfolio of core commercial properties located throughout the UK, comprising offices, retail and industrial buildings. The Local portfolio is to be a portfolio of investment properties located in Lancashire.

The Fund's UK portfolio was first set up in 1988 and as at 31 March 2013 comprised 55 properties valued at £434m. It has been managed by the property agents, Knight Frank since inception.

As part of the overall investment strategy, the Pension Committee has approved an allocation to local investment of 3% of the Fund value. It is anticipated that this allocation will be largely invested in commercial property in the County of Lancashire (the Local portfolio). The City Deal is anticipated to provide a significant flow of investment property opportunities for the portfolio. On the current Fund value of around £5bn, this represents an allocation to local investment of up to £150m

The management of a property portfolio involves three separate services:

- *The property investment manager* is responsible for the overall investment performance of the portfolio. The investment manager designs the investment strategy for the portfolio and determines which properties either enter or leave the portfolio.
- *The property estate manager* is the property professional responsible for the smooth running of the Fund's properties. The estate manager deals with property lettings, rent collection, as well as building and estate repairs and management, where these are the responsibility of the landlord.
- *The Independent Valuer* prepares independent valuations of the Fund's properties for inclusion in the Fund's accounts. The Independent Valuer determines what value a property would be expected to reach if sold between a willing buyer and a willing seller in the course of a normal commercial sale.

The existing UK property management and valuation contracts have been in place since 2000. Throughout this period and since inception of the portfolio in 1988, the performance of the property portfolio has met its benchmark suggesting there is little need to revisit the existing contracts. However, the contracts have been in place for 13 years and it is best practice to market test contracts on a regular basis. Recent renegotiation of aspects of the existing contract to obtain better value for money suggest there are further value for money improvements to be obtained in the current competitive environment. Market testing also provides the Fund with the opportunity to compare the current property investment strategy with the latest thinking of other property agents. The need to set up property management arrangements for the new Local portfolio means that this is an opportune moment to put the management of both the UK and the Local portfolio out to tender.

Existing and Proposed Management Arrangements

The existing UK portfolio property management arrangement includes both investment management and estate management services in a single contract with the property agents, Knight Frank. This means that the two separate arms of Knight Frank, Investors and Property Management report in parallel to the Fund. While part of the same group, Knight Frank Investors and Knight Frank Property Management operate quite separately from each other.

This arrangement creates a mis-alignment of responsibilities. As investment managers, Knight Frank Investors should have full responsibility for the performance of the property portfolio. However, the performance of Knight Frank Property Management, over which Knight Frank Investors has no direct control, can have a

significant effect on the portfolio values and performance (for example, through lease re-negotiations, asset management initiatives, repairs and refurbishments).

It is proposed that the Fund initially undertakes a procurement exercise to appoint the property investment manager, who will then be mandated to procure and appoint a property estate manager. The estate manager may well not be from the same group as the investment manager. This contractual structure will give the property investment manager direct control over the estate manager and full responsibility for all aspects of the performance of the portfolio. It is believed that this structure will produce the best returns for the Fund.

The current investment management mandate is an advisory mandate with Knight Frank Investors having to seek the approval of the County Treasurer for every proposed property acquisition or disposal.

In common with the Fund's other investment mandates, it is proposed that the new property investment mandate be a discretionary rather than an advisory mandate, with the investment manager then fully responsible and accountable for the performance of the property portfolio.

It is proposed that as part of this revised approach the property investment manager be required to produce an overall property investment strategy which will be subject to the approval of both the Investment Panel and the Pension Fund Committee. This strategy will set out not only how the manager expects to meet the investment return targets set out in the Statement of Investment Principles but also define prudential limits for risk management of the portfolio. These prudential limits will not only place limits on lot sizes and tenant exposure, but will also include such matters as the conditions around and extent to which the investment manager may undertake development expenditure or acquire vacant property speculatively.

It is also proposed that an advisory board-type arrangement be set up with the detailed constitution to be agreed between the Investment Panel and the property investment manager. An advisory board structure with representatives of investors and the manager is common amongst private equity and unlisted investment funds. The property investment manager will be required to produce an annual business plan for the implementation of the investment strategy for approval by the advisory board. The advisory board will also receive quarterly performance reports and will be consulted prior to any investment decisions.

It is proposed that a single procurement will be undertaken for both the UK and Local investment management mandates, with bidders able to bid for either one or both of the mandates. This will give commercial property estate agents with specialist local knowledge and the capacity to service property portfolios at a local level only, the opportunity to bid for the local investment management mandate. It will also give the Fund the opportunity to weigh the advantage of specialist local knowledge against any economies of scale to be gained from a single property investment mandate comprising both national and local portfolios.

The procurement of the independent property valuer will be for the annual valuation of both the Local and the National portfolios.

The Fund proposes to run the procurement in-house with the assistance of the One Connect Procurement Centre of Excellence and take appropriate specialist professional advice where necessary on the construction and scoring of the technical questions.

It is proposed to use the restricted tender process (the detail of which is set out below) with a view to making a decision on investment managers for the Local and UK portfolios by the end of 2013 and an implementation with effect from 1 April 2014, or earlier if practicable.

The restricted tender process is a two stage process. Stage 1 is a qualifying stage from which 3 to 5 bidders are taken through to Stage 2 when detailed proposals are requested.

Stage 1 is about identifying bidders with the capacity to deliver the service and will involve evaluation of the following matters:

- Business and Corporate Structure
- Staff
- Risk management
- Performance
- Track Record
- Mandates won and lost
- Sustainability and responsible property investment
- Equal opportunities
- Health and safety
- Referees
- Professional indemnity and others insurance

Stage 2 involves an understanding and evaluation of the bidder's portfolio strategy, investment style and fee structure. Stage 2 will require the potential manager to sign a Non-Disclosure Agreement as a comprehensive Fund information pack will be sent out outlining the details of the UK portfolio (and the Local portfolio if any acquisitions have been completed prior to issuing the tender). The pack will include information on the overall Fund philosophy and style and all available property details such as recent valuation reports containing the tenancy schedules.

In Stage 2 bidders will be required to provide

- Investment policy and style
- Investment process
- Proposed Strategy
- Potential Returns
- Sustainability
- Fees

- People

In its assessment of fees, the Fund will seek an arrangement which links the manager's remuneration to the performance of the property portfolio.

A similar restricted tender process will be used to appoint an independent valuer to the Fund.

The broad award criteria are provisionally assumed to be:

Award Criteria	Weighting
Price	30%
Capacity and capability of the tenderer to provide the services	25%
Details of the tenderer's methods of working	20%
Experience of comparable service provision	25%

Consultations

N/A

Implications:

This item has the following implications, as indicated:

Risk management

With the existing contracts and their partial renegotiation, the Fund might forego any further benefit to be gained from opening the contract to rival bidders.

Local Government (Access to Information) Act 1985

List of Background Papers

Paper	Date	Contact/Directorate/Ext
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N/A

Reason for inclusion in Part II, if appropriate

N/A