Leicestershire County Council Pension Fund

Property review

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Introduction

- This paper is addressed to the Investment Sub-Committee ("ISC") of Leicestershire County Council Pension Fund ("the Fund").
- The strategic allocation to property was formalised at 7.5% following the 2025 Strategic Asset Allocation (SAA) review. Building on this, this paper takes a deeper look at the Fund's property allocation, assessing the suitability of sub-allocations and current managers, considering the divergent performance across different property sectors, ongoing pooling requirements, and available solutions via the Pool.
- This paper should not be used for any other purpose. It should not be released or otherwise disclosed to any third party except as required by law or with our prior written consent, in which case it should be released in its entirety. We accept no liability to any other party unless we have accepted such liability in writing. We provide comment from an investment but not a legal or tax perspective.

Executive Summary

As at 31 December 2024, the Fund held £483.9m in property, representing 7.3% of total assets and broadly in line with its revised 7.5% strategic target set during the 2025 Strategic Asset Allocation review. The portfolio spans five mandates across both direct and indirect holdings. Investment performance has been satisfactory overall, reflecting the transitional nature of the portfolio and recent stabilisation in market conditions.

What's Changed Since the 2022 Review?

The last review of the property portfolio took place ahead of the UK property market peak in 2022 and in very different broader market conditions. At that time, progress in building out the UK direct property portfolio had been slower than expected. LGPS Central had selected a UK property investment manager (DTZ) but the Pool's portfolio had not yet launched. The UK property funds market had not yet come under pressure with redemptions. Since then, several developments have occurred:

- The Central fund is now live and building momentum — offering a scalable and more cost-effective route to grow the Fund's direct property exposure.
- DTZ now manage all of the Fund's direct mandates: the LGPS Central UK Direct Property Fund, the Fund's segregated UK portfolio (formerly with Colliers), and two legacy Aegon Active Value funds that are in wind-down. c.£210m is currently invested, with a further c.£50m committed for deployment in 2025.
- Many UK pooled funds have been suffering from ongoing redemption pressure; some funds have entered into wind down and the long term viability of others is being questioned. It's clear that the UK property funds index is shrinking; we expect there to be fewer funds to choose from going forward and many of the surviving funds will be smaller than they were previously.
- LaSalle were asked to pivot the portfolio to increase the Fund's exposure to overseas property, but progress has been slow due to liquidity constraints across the market impacting underlying holdings. The mandate is currently around £275m, with only £52m invested overseas.
- LaSalle has lost some UK multi-manager clients as a result of LGPS pooling and has not replaced these mandates. The indirect team has also experienced senior turnover as a result.
- The UK property market is correcting more quickly than overseas markets, now making it more attractive than other regions on a forward-looking basis.
- In early 2025, it was agreed that the Fund's target allocation to property would be reduced from 10% to 7.5% of total assets; the new target broadly being in line with the current allocation. However we don't believe the reduction in target allocations should be spread equally across each of the Fund's different real estate mandates/strategies.

We have confidence in both DTZ and LaSalle — DTZ for managing the Fund's direct property exposure, and LaSalle for its indirect mandate — but these developments point to the need to refocus how the Fund invests in property going forward.

Executive Summary

Recommendations

We continue to view the target allocation of 7.5% to property as appropriate, and **no further commitments are needed at this stage**. However, we recommend that the Fund refines the structure of the sub-allocation targets within the property portfolio in the following ways:

1. **Increase the UK allocation, from 60% to 70%.** Investing globally comes with additional risks (for example typically more leverage risk) that are only worth taking if expecting to be adequately compensated for doing so; these additional risks haven't led to materially better performance historically, and forecasts suggest the overseas is unlikely to outperform over the next 3-10 years.

2. **Increase the amount managed by DTZ, from 40% to 60%.** Whilst we still believe LaSalle are a suitable manager, there has been some staff turnover and loss of clients in recent years. On the other hand, DTZ are performing well and have the added advantage of being directly appointed by Central, hence aiding with the pooling direction.

3. **Increase the amount which is directly managed, from 40% to 60%.** Investing directly is the most cost-effective implementation route, and we believe a portfolio of greater scale would be beneficial. A 60% allocation equates to c£300m based on current asset values; this would increase over time as the Fund's asset base grows. On the other hand, the indirect market (particularly in the UK) has struggled post-2022 and we are seeing an ongoing shrinkage of the universe of UK funds.

4. **Remove the specific target allocation to indirect UK property.** Instead, LaSalle should be asked to run a Global mandate i.e. with discretion to bias towards or away from the UK depending on their perception of the relative opportunities. LaSalle should also be asked to bias towards parts of the market not easily accessed through direct investment e.g. Residential / Value Add.

5. **Increase the Core / decrease the Residential and Value Add target ranges modestly.** This is to allow for the changes above i.e. a higher core and lower value-add/residential allocation is expected once DTZ manage c.60% of property assets.

We estimate that moving to the proposed structure could save the Fund c.£0.6m p.a. in fees, compared to the 2022 structure.

From an RI perspective, this shift is expected to improve the Fund's ESG profile. DTZ are more advanced in integrating ESG considerations, have a well-established net zero framework, and offer greater control over implementation as a direct manager.

Executive Summary

Implementation Considerations

LaSalle would be asked to assess the current portfolio and set out a plan to reduce the mandate accordingly.

We note that LaSalle is still some way off reaching the interim target set back in 2022 as a result of difficult market conditions. This means an update to the target allocations should not impact or undo any new investments made since 2022.

As a first step, we recommend instructing LaSalle to pause making any further new commitments to underlying funds until a revised plan is agreed, while honouring any commitments already made.

We note that LaSalle is already in the process of selling down more indirect UK holdings (£53m). Rather than committing this to new overseas investments, we would suggest that this capital is re-directed to DTZ as the pool’s direct property fund manager.

DTZ will also require time to identify, underwrite, and transact on suitable opportunities. We recognise that the recommendation is still a significant change that will take a number of years to fully transition. We would not wish to rush this process and believe minimising transaction costs should be a key focus rather than speed.

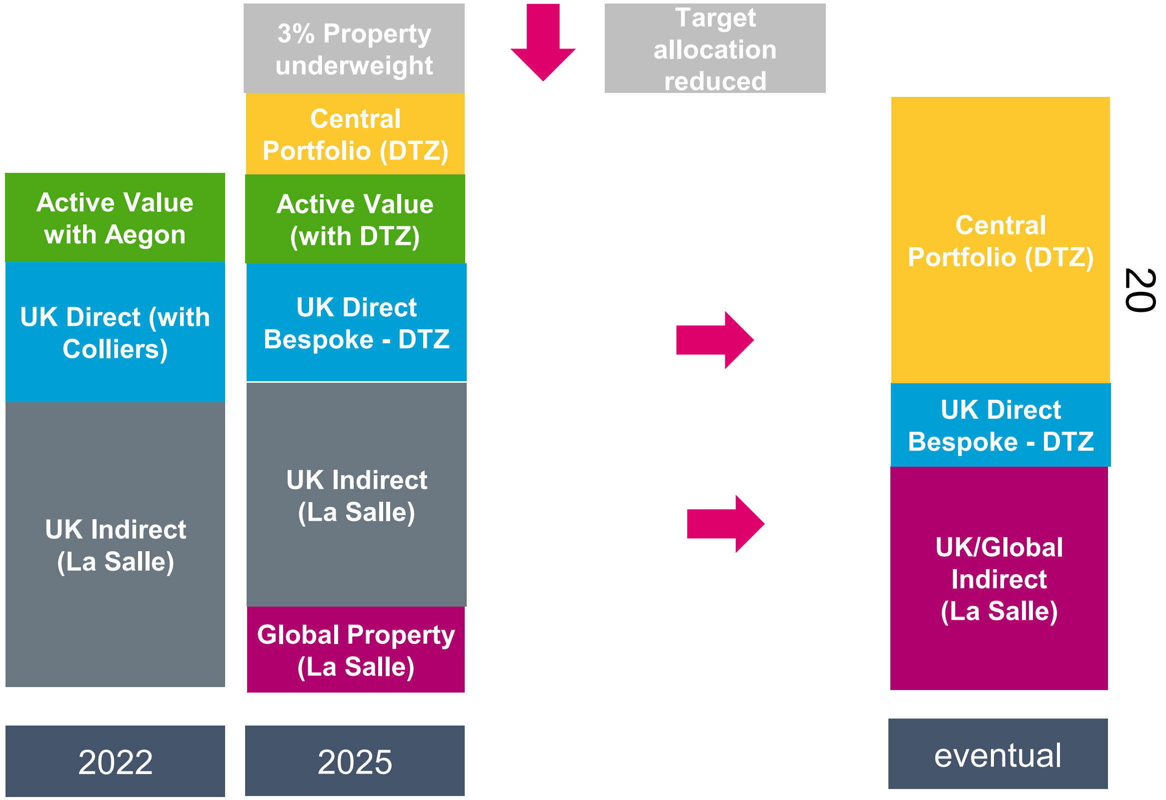
Agreeing a plan with LaSalle and DTZ accordingly will be important to achieve the intended objectives.

Executive Summary

Proposed revised target

		Current Allocation	2022 structure	Proposed revised target
Regional split	UK	88%	60%	70%*
	Global	12%	40%	30%
Manager split	DTZ	44%	40%	60%
	LaSalle	56%	60%	40%
Investment Channel	Direct	44%	40%	60%
	Indirect	56%	60%	40%
Risk	Core Commercial	59%	65 – 80%	70 – 90%
	Residential	13%	10 – 15%	Up to 15%
	Value-add Commercial	28%	10 – 20%	Up to 20%

Expected evolution of property portfolio



* Note that the revised LaSalle mandate would be Global (i.e. UK and Overseas) with full discretion given to the manager. For the purpose of this illustration we have assumed an eventual split of 10% UK and 30% overseas.

Why invest in real estate

The rationale for the inclusion of property within a pension scheme's investment strategy is primarily a combination of the following:

Diversification from other asset classes

Relatively stable income, with some inflation protection

Capital growth, linked to broader market but can also be driven by manager skill

Advanced understanding of environment, social and governance considerations which can drive value-add

Where does real estate fit in a portfolio?

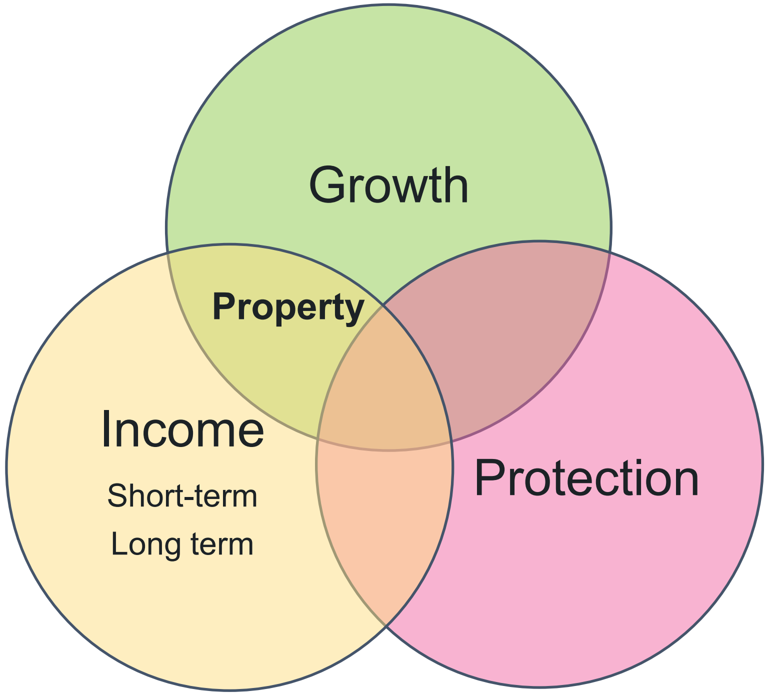
- Investors receive rental income in exchange for giving a third-party use of their building
- Cross between bonds (regular income stream) and equities (price moves with demand)

Only suitable for clients with:

- An appetite for risk
- Desire to diversify:
  - growth assets or
  - Income assets
- Tolerance for illiquidity
- Ability to invest over the medium-long term

Real estate can provide:

- A decent income yield
- Capital growth
- Some inflation resilience
- Low corelation with, and therefore diversification from, other asset classes



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Investing responsibly

- RI is an important component of any real estate allocation
- Managers need to make routine, and sometimes substantial, improvements or properties would become obsolete
- It is important to understand the strategy and targets of any specific mandate

Environmental

- Improving the energy efficiency of the buildings can make a difference towards real world change
- Growing awareness of climate risks (e.g. flooding, heat stress) is boosting demand for energy-efficient and resilient buildings, driving higher rents and asset values (green premium)
- EPC ratings, climate targets

Social

- Lots of ad-hoc examples of improving social aspects from commercial property funds
- Working with and supporting local communities, creating jobs, apprenticeships

Governance

- Engagement with tenants
- Engagement with sub-contractors
- Driving best practices

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Most UK property fund managers submit ESG data to GRESB annually. GRESB participation is also becoming increasingly expected by institutional investors globally.

Recap: target structure proposed in 2022 review

Approach	Allocation	Sub-allocation	Pros and cons
Segregated direct	40%	Two directly managed UK commercial sub-portfolios Focussed on core/core-plus assets Mandate allows capital to be deployed flexibly across both core and alternative sectors	More control But big capital commitments needed Likely limitations to types / quality of properties without scale Less diversified
Multi-manager	60%	Target split of 60%: 20% UK Indirect 40% Global Indirect (interim target 25% by 2025-2027)	Exposure to commercial property that the Fund cannot access directly due to scale Increased diversification Potential to capture secondary market opportunities Includes diversifying specialist strategies, such as value-add and residential opportunities More expensive

Objectives:
- Deliver attractive risk-adjusted returns
- Enhance diversification
- Gain exposure to the benefits of direct investment (in UK commercial property at least)

Journey since last property review

The decision was made to:

- ✓ Commit to the LGPSC Direct Property Fund.
- ✓ Approve the appointment of LGPSC (DTZ) to manage the existing direct portfolio.
- ✓ Retain La Salle as indirect property manager.

Challenges faced in the property market

The property market has faced a series of challenges since the post-pandemic period, with pressures intensifying following the UK gilt crisis in late 2022. Sharp interest rate rises, falling asset valuations, and refinancing difficulties have all weighed on sentiment and outlook, while structural shifts (e.g. hybrid working) and ESG requirements have added to longer-term headwinds. Liquidity has also become a concern, with redemption queues in some open-ended funds slowing disinvestment from indirect property holdings.

Is now the time to close the underweight?

We have seen some improvement in several of the fundamental indicators for UK commercial property.

However, these improvements come off a particularly low base. Transaction volumes still remain low relative to history and selling pressure remains

June 25 (present)

Last property review (H1 2022)

Implementing agreed changes

2025 SAA review

Progress:

1. Invested in LGPSC UK Direct Property Fund (inception date: November 2023)
2. Agreed further commitments to La Salle to close the underweight in property. It was expected that this would happen in 2024, with capital returns from Aegon or cash reserves covering these commitments. However due to a weak property outlook at the time, the closure of the underweight was deferred.

Outcome:

Rather than continued deferment of closing the underweight, **the strategic allocation has been formalised closer to the current weight at 7.5% (previously 10%)**, aligning with the existing c.7% allocation.

In-depth property review

What’s changed since 2022?

- The last review of the property portfolio took place ahead of the UK property market peak in 2022 and in very different broader market conditions.
- At that point, a new direct property fund manager had recently been selected by the Pool. LGPS Central had selected DTZ to manage UK property investments, but the Pool’s portfolio had not yet launched.
- Now that DTZ is in place and managing assets for the Pool and Fund, we would seek to grow this element of the portfolio.
- At the time of the last review the UK property funds market had not yet come under pressure with redemptions. Since then, many UK pooled funds have been suffering from ongoing redemption pressure; some funds have entered into wind down and the long term viability of others is being questioned. It’s clear that the UK property funds index is shrinking, we expect there to be fewer funds to choose from going forward and many of the surviving funds will be smaller than they were previously.
- The Fund’s indirect manager, La Salle, has lost some UK multi-manager clients as a function of LGPS pooling. The indirect team has also experienced a loss of senior resource.
- The UK property market is correcting more quickly than overseas markets, now making it more attractive than other regions on a forward-looking basis.
- In early 2025, it was agreed that the Fund’s target allocation to property would be reduced from 10% to 7.5% of total assets; the new target broadly being in line with the current allocation. However we don’t believe the reduction in target allocations should be spread equally across each of the Fund’s different real estate mandates/strategies.

Recommendations – UK property

- The Fund has a target allocation of 7.5% to property, this equates to roughly £500m-550m. The current property allocation is c£484m, with a further c.£50m due to be deployed into the LGPSC UK Direct Property Fund. Based on high-level calculations, and taking into account the undrawn commitment to Central, we therefore do not recommend a need to commit new money to property for the time being.
- An allocation of this size allows the Fund to invest directly, which is the most cost-effective implementation route. For a direct mandate to be successful, we believe it needs to be of scale. Combined, the 4 mandates now managed by DTZ total just over £210m, growing towards £260m once further commitments have been drawn. This remains towards the lower end of what is needed to create a well diversified direct portfolio, in our view.
- Our preference would be for the Fund to eventually invest over £300m of its property assets directly in order to build a direct portfolio of more sufficient scale. This would reduce ongoing management costs and allow the Fund greater potential to consider local opportunities as part of the allocation in future, should they wish to do so. It would also result in a greater proportion of assets being managed directly by the Pool.
- DTZ IM is a strong UK property investment management business and we are confident in its ability to transition the Fund's property assets into a better considered portfolio over time. Where feasible, DTZ opts for asset improvement strategies over portfolio rotation, to minimise transaction costs. We would support allocating more capital to DTZ in order for the Fund to create a more robust direct mandate of scale over time.
- We believe that as the Fund's direct allocation grows, its need for indirect funds will reduce. The previous target of 20% to UK indirect now seems high in relation to the direct mandate, and becomes less necessary if the direct mandate gains more scale, particularly given the post-2022 struggles and ongoing shrinkage of the universe of UK funds.
- Going forward, we believe the multi-manager mandate should be used increasingly to access parts of the market the direct mandate can't access, either due to size restrictions, specialist expertise or geography.

Recommendations – global component

- At the last review we recommended a long-term target of 40% of property assets invested globally, with an interim target of 25%. This was based on analysis we carried out of the optimal allocation to maximise portfolio efficiency based on historic returns and volatility data to 2020. Our updated analysis with returns and volatility data updated to end 2024 produces a similar outcome (as does analysis from LaSalle Investment Management).
- The previous target split was set in different market conditions, with a larger expected total allocation to the asset class. This is relevant as the optimisation analysis doesn't take into account the inefficiency of having a sub-scale UK direct property portfolio (since it uses index level data) or market return forecasts.
- We note that a number of real estate research houses (including LaSalle) are expecting higher returns from the UK property market compared to other regions in the coming years. Likely, and at least partially, due to the UK property market correcting more quickly than other regions. Investing globally comes with additional risks (for example typically more leverage risk) that are only worth taking if expecting to be adequately compensated for doing so; as demonstrated earlier these additional risks haven't led to materially better performance historically (and has likely been at least in part driven by the higher leverage), and forecasts suggest the overseas is unlikely to outperform over the next 3-10 years.
- We would therefore recommend that LaSalle is asked to assess the current portfolio with a view to putting a plan in place to reduce the mandate from its current size of £275m to a size of around £210m over the next 3-5 years (around 40% of current property allocation once the additional £50m is drawn by Central).
- LaSalle's split between UK and overseas funds will initially be determined by current exposure and LaSalle's assessment of liquidity options and market expectations. We would suggest that LaSalle's objective and target geographical split would be reviewed again once the mandate approaches the smaller target size, although we suggest LaSalle are given discretion to invest this globally as they see fit i.e. taking into account the relative merits of UK vs Overseas markets.

Recommendations – direct vs indirect

- Investing directly gives the Fund more control over investments, and at a reduced cost.
- We believe building a UK direct portfolio of scale should be a higher priority for the Fund now that DTZ is in place and the UK market looks more attractive than overseas markets on a relative basis.
- We believe a UK direct portfolio of greater scale will bring benefits to the Fund as a larger mandate would allow DTZ to consider a wider opportunity set of UK investments and potentially more dominant, or prime, assets that may offer better risk-adjusted returns. For example, rental growth expectations is currently stronger for better quality space and in some cases, improvement works to make buildings more energy efficient are only worth doing in prime locations that can command top rents.
- This would also bring down fees across the property portfolio, as indirect fees are materially higher on a look through basis. We estimate that moving to the proposed structure could save the Fund c.£0.6m p.a. in fees, compared to the 2022 structure.
- We note that LaSalle is still some way off reaching the interim target set back in 2022 as a result of difficult market conditions. This means an update to the target allocations of the type we are recommending should not impact on or undo any new investments made since 2022.
- We also note that LaSalle is already in the process of selling down more indirect UK holdings, which would support the new strategy.
- That said, we recognise that the recommendation is still a material change in long-term strategy, and achieving that strategy will take a number of years to fully transition. We would not wish to rush this process and believe minimising transaction costs should be a key focus rather than speed.

Recommendations – from an RI perspective

- The recommended changes are supported by RI considerations which strengthen the long-term sustainability of the strategy.
- The recommendations involve investing more through DTZ and less through LaSalle; we rate DTZ more highly than LaSalle on RI matters and we also note DTZ’s more ambitious Net Zero target date.
- Furthermore, as a direct property investment manager, DTZ has more control over progress in areas such as RI, relative to LaSalle as an indirect / multi manager (who depend on underlying managers to implement their strategies).
- The UK has better established standards than some other overseas markets. For example, UK managers tend to participate in GRESB more than some overseas regions (though we note GRESB participation is also becoming increasingly expected by institutional investors globally). UK managers also report EPC ratings, as this is a regulatory requirement, whereas no equivalent requirement exists in many other regions.
- We are therefore comfortable that the recommended changes will not only improve the Fund’s RI characteristics, but also support long-term financial outcomes — by increasing exposure to assets that are more attractive to occupiers, better positioned to benefit from green premiums, more resilient to future regulatory change, and less exposed to reputational risks linked to poor ESG performance.

Thank you

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