

The Rt Hon Andrea Leadsom MP
Secretary of State for Environment, Food and Rural Affairs
Nobel House
17 Smith Square
London
SW1P 3JR

21st September 2016

Dear Secretary of State,

CANAL & RIVER TRUST: REPORT OF THE PROTECTOR

Introduction

The Grant Agreement (“the Agreement”) dated 28th June 2012 made between The Secretary of State for Environment, Food and Rural Affairs (“Defra”) and Canal & River Trust (“CRT”) provides that the parties shall appoint jointly a person as the Protector of the Protected Assets. The Protected Assets comprise the Investment Assets (principally property held for investment purposes) and the Protected Operational Assets as defined in the Agreement.

I have been appointed as the Protector and this is my third formal report to Defra, covering CRT’s Financial Year ended 31st March 2016.

The role of the Protector

The role and duties of the Protector are defined in the Agreement. The key requirement is that the Protector shall monitor compliance by CRT with the provisions of Schedule 8 of the Agreement to ensure there is no Material Diminution or Material Diversion. The role includes receiving CRT’s Annual Investment Plan (“AIP”) and any review or revision by CRT of the Group Investment Policy (“GIP”). Under the Agreement the Protector is required to give feedback and comments to CRT on the AIP and GIP, as appropriate.

The Agreement entitles the Protector to receive Minutes of meetings and other reports and information as may be reasonably required in order to fulfil the role.

There is a mechanism for the Protector to issue warnings in the event of threatened or actual Material Diminution or Material Diversion, and a Non-compliance Notice following a failure to sufficiently satisfy conditions relating the implementation of a plan to address concerns raised by the Protector.

Lastly, the Protector is required to report annually to Defra on the management of the Investment Assets by reference to performance against the objectives of the GIP.

Process

During the course of the year I have spoken with Officers of CRT on numerous occasions; in person at their offices in Little Venice, London, and by telephone. In the capacity of observer I have attended meetings of CRT's Investment Committee and have been provided with various Minutes, reports and other information, including the annual property valuation (as at 31st March 2016) prepared by CRT's External Valuer, GVA. I have also had sight of the investment performance report relating to the majority of the properties held for investment purposes prepared by MSCI (formerly known as IPD), the Trustees' Annual Report and Accounts 2015/16 and the Pro Forma Accounts for the Canal & River Trust Protected Endowment (for the year ended 31st March 2016).

I have reviewed the documents referred to above and where appropriate sought clarification or further information. I have also informally discussed the tone of the property valuation with GVA.

As required by the Agreement I have provided feedback and comments to CRT where I considered it appropriate to do so.

My opinions and conclusions are of course reliant upon the completeness and accuracy of the information with which I have been provided, but I am not aware of any material omissions or areas of concern.

Principal Findings

1.0 During the year CRT managed the Investment Assets by reference to the GIP dated March 2013 (with subsequent revisions). The GIP sets out various operating principles and the means by which the policy will be implemented. Key items include:

- 1.1 To maximise the total returns (income and capital gains) of the Investment Assets without taking undue risk over the medium to long term.
- 1.2 To preserve and grow the value of the Investment Assets in real terms.
- 1.3 Not to use the Investment Assets, nor investment proceeds, in any manner that is inconsistent with CRT's objects.
- 1.4 To manage risk and liquidity in a manner consistent with the investment objectives and the needs of CRT in meeting its obligations under the terms of the Agreement.

2.0 The Investment Committee of CRT did not propose any amendments to the GIP during the year ended 31st March 2016.

3.0 In the 12 months to end-March 2016 the total net value of the Investment Assets (excluding the pension fund liability) rose from £714.8m to £752.7m; an increase of £37.9m (+5.3%). (See Annex A: Protected Endowment Fund Balance Sheet as at 31 March 2016.)

- 4.0 During the year, CRT sold 75 properties for a total consideration of £27m and bought 7 properties for a total price of £38.1m. In aggregate the properties which were sold achieved a price some 54% above their combined value at the start of the period. The switch from lower to higher average lot sizes was in line with the strategy to improve operational efficiency.
- 5.0 As at March 2016 the Investment Assets included 481 properties (excluding boating properties), of which the top 100 accounted for about 94% of the total property value.
- 6.0 Void properties (ie, those which are not income producing) accounted for ca. 1.5% of the total estimated rental value of the property investment portfolio. This figure excludes assets that are not intended to be let in their current condition; for example properties held for development.
- 7.0 Those property investment assets that are measured by MSCI (having a total value of £549.4m), produced a total return of 13.7%. This figure reflected an income yield of 5.4% and a capital return of 7.8%. For comparison, the market return, as measured by MSCI, was 11.1% for the 12 months to end-March 2016. Inflation, as measured by the Retail Prices Index (RPI), during the same period stood at 1.6%.
- 8.0 During the year CRT continued to implement its strategy to divert part of the Investment Assets away from property and into other asset classes. One of the principal aims of this policy is to achieve greater diversification, thus improving the risk/return balance. The additional monies invested during the year (£20m) were placed using an outsourced investment office arrangement under a services agreement with Partners Capital, and brought the total invested via Partners Capital to £100m. The value of this fund as at March 2016 stood at £99.6m and the return earned by fund during the 12 months was minus 2.8%, compared to the bespoke Partners Capital Benchmark of minus 1.8%. As the total return was below the target (5% + UKCPI +1%), and in accordance with the investment policy, CRT only withdrew the natural income yield of 2% (comprising dividends and interest) and did not realise any of the capital. As noted last year, the underlying investments managed by Partners Capital may not be as liquid as, for example, quoted securities or commercial property, therefore the degree of confidence with which they can be ascribed a market value may be lower.
- 9.0 As forecast, the rate of return from property investments was lower than that seen in the two previous years, although ahead of what had been expected at the start of the year. In part this stronger performance can be attributed to attraction of the relatively high-income yield from property compared to bonds and other income producing assets, which resulted in further yield compression. The outlook however remains uncertain and the result of the EU Referendum has increased concerns that the property market may suffer a price correction in the coming months. In the case of CRT a general market re-pricing may be at least partly mitigated by the significant holdings of ground rents, which being of long duration and inherently lower risk, exhibit attractive bond-like characteristics. The investments in the portfolio managed by Partners Capital also provide a property diversifier.

Conclusions

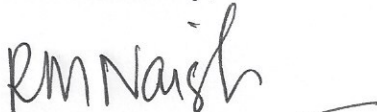
To the best of my knowledge I have been provided with all the information necessary to perform my role, and CRT have responded positively to my questions and feedback.

Based on my discussions with Officers of CRT and the evidence I have seen, I consider that CRT have managed the Investment Assets in accordance with the Group Investment Policy and that the GIP is in compliance with the statement of Agreed Purposes in the Grant Agreement.

The total value of the Investment Assets increased during the year-ended 31st March 2016. Although the investment performance of the assets managed by Partners Capital fell short of the bespoke benchmark, the return from the investment property portfolio was ahead of the market average and very significantly above inflation.

Having regard to this I have not detected actual Material Diminution to the Investment Assets or a Material Diversion of Protected Assets to purposes other than the Agreed Purposes as defined in the Agreement. As noted under heading 9.0 above, there is currently significant uncertainty as to the future direction of commercial property values and a fall is considered by many commentators to be likely. If this were to happen CRT may be partly cushioned from the full impact due to the structure and nature of their investment portfolio but at least some diminution in value could occur.

Yours sincerely,

A handwritten signature in black ink that reads "R M Naish". The signature is written in a cursive style with a long horizontal flourish extending to the right.

R M Naish
Protector

Annex A

**PROTECTED ENDOWMENT FUND
BALANCE SHEET
AS AT 31 MARCH 2016**

	Note	Group 31 March 2016 £m	31 March 2015 £m
Fixed assets			
Tangible assets	2	54.5	54.3
Investments:			
Property	3	580.0	522.9
Diversified funds	4	99.6	84.4
Subsidiaries	5		-
joint ventures:			
share of gross assets	5	25.9	38.3
share of gross liabilities	5	(6.1)	(11.1)
		753.9	688.8
Debtors: Amounts falling due after more than one year			
	6	-	8.6
Current assets			
Stocks		0.2	0.2
Debtors	6	11.6	18.1
Investments – short term bank deposits (C&R Re)		6.0	6.1
Cash at bank and in hand	7	17.2	33.7
		35.0	58.1
Current liabilities			
Creditors: Amounts falling due within one year	8	(20.9)	(24.6)
Net current assets		14.1	33.5
Total assets less current liabilities		768.0	730.9
Creditors: Amounts falling due after one year	8	(13.0)	(13.0)
Provisions for liabilities	9	(2.3)	(3.1)
Net assets excluding pension fund liability		752.7	714.8
Pension fund liability	11	(51.3)	(87.9)
Net assets including pension fund liability		701.4	626.9
Protected endowment fund			
Subsidiaries		37.4	21.2
Other funds		664.0	605.7
Total fund	10	701.4	626.9