Lincolnshire COUNTY COUNCIL
Working for a better future

Regulatory and Other Committee

Open Report on behalf of Executive Director of Finance and Public Protection

Report to:	**Pensions Committee**
Date:	**16 July 2015**
Subject:	**Annual Report on the Fund's Property Investment**

Summary:

This report outlines the performance of the Fund's property and related investments for the year ended 31st March 2015.

Recommendation(s):

That the Committee note this report.

Background

1 Introduction

1.1 Investment exposure to Property is achieved via holdings in pooled vehicles. The Fund, with a strategic allocation of 11.5%, has traditionally allocated significantly more to the property asset class than the average local authority pension fund (currently 7%). The market value of holdings in pooled vehicles at 31st March 2015 was £189.6m (11% of the Fund). To diversify the property allocation and invest cash flow, the Fund made commitments to European Commercial Property (2002), property venture type funds (2005 and 2006), Private Finance Infrastructure Schemes (2004, 2006, 2007 and 2013) and Asian Commercial Property (2007).

Market value of property and other holdings at 31 March 2015

Property Pooled Investment Vehicle	Undrawn Commitments 31/3/15 £m	Market value of LCC holdings 31/3/15 £m	Total size of pooled vehicle 31/3/15 £m
BALANCED UK PROPERTY			
Aviva Pooled Property Fund	n/a	38.2	1,200.0
Royal London Exempt Unit Trust	n/a	19.3	357.0
Blackrock – UK Property Unit Trust	n/a	19.3	3,010.0
Standard Life - Trustee Investment Plan	n/a	56.6	1,297.0
Total UK Commercial Property		**133.4**	
PROPERTY VENTURES			
RREEF – Property Ventures Fund III	0.0	2.9	42.9
Franklin Templeton European Fund of Funds	0.4	3.1	44.0
Franklin Templeton Asian Fund of Funds	3.2	8.3	128.5
Igloo Regeneration partnership	0.0	5.1	76.8
Total Property Ventures	**3.4**	**19.4**	
EUROPEAN COMMERCIAL PROPERTY			
Standard Life European Growth Fund	0.0	8.7	742.0
INFRASTRUCTURE			
Innisfree PFI Continuation Fund II	0.2	7.6	
Innisfree PFI Secondary Fund	1.4	13.7	
Innisfree PFI Secondary Fund 2	2.5	6.8	
Total Infrastructure	**4.1**	**28.1**	
TOTAL PROPERTY	**7.7**	**189.6**	

2 Balanced UK Commercial Property

2.1 During the year income from the holdings was reinvested but no additional new money was invested and no redemptions were made.

2.2 The pooled investment vehicles have been selected by officers to provide diversified exposure to the UK Commercial Property asset class with the intention of achieving broad market returns. Officers are in regular contact with the various managers to monitor performance.

2.3 Appendix A illustrates the overall UK property sector and regional weightings of the individual pooled vehicles. Overall, the Fund's property allocation, when compared to an index of similar property funds, is overweight Shopping Centres, Retail Warehouses, Offices in London the "Other" sector (this includes properties such as leisure and residential and listed assets) and cash. The Fund is underweight Standard Retail, Offices in the South East and the rest of the UK, the Industrial sector in the South East and the rest of the UK.

Overall UK property sector asset weightings at 31st March 2015

Property Sector	LCC Fund %	IPD %	Difference %
Retail	35.4	32.3	3.1
Offices	28.9	30.1	(1.2)
Industrial	18.0	23.2	(5.2)
Other	17.7	14.4	3.3
Total	100	100	

2.4 At an individual fund level:

- Royal London has a significant relative allocation to Standard Retail, Offices in London and the South East and the Industrial Sector in the rest of the UK. Royal London has no allocation to Shopping Centres. Property sizes are generally smaller when compared to the other managers.

- Aviva has no allocation to Shopping Centres and is overweight Standard Retail, Retail Warehouse and Offices in the London and the South East. Underweight positions are underweight Industrial in the rest of the UK and cash.

- Blackrock is overweight Retail Warehouses and heavily overweight Other Properties. They are underweight in Standard Retail, Offices in London and the rest of the UK.

- Standard Life is overweight Standard Retail, Shopping Centres and Offices in the rest of UK and London, and underweight Other Property, Industrials in the rest of the UK and Offices in the South East.

3 Market Environment in the Period Reported and Outlook

- Property produced total returns of 16.6% (IPD index), over the twelve months to 31st March 2015, compared to UK equity returns of 6.6% (FTSE All Share) and UK index-linked bond returns of 18.6%.

- Quarter 2 2014 - The improving economic backdrop in the UK remains supportive for recovery in commercial real estate. This is resulting in positive returns for investors, who are becoming more confident in the recovery's sustainability. For example, the latest Investment Property Forum (IPF) data showed that consensus return forecasts for 2014 increased to 13.7% from 12.1% previously.

- Quarter 3 2014 - The UK continued to lead the recovery in global real estate markets, supported by improving economic data. This included an upward revision to second-quarter GDP growth, generally positive forward-looking PMI indicators and improving business sentiment surveys, all of which pointed to a broadening recovery. Eurozone weakness prompted some residual caution, given the UK's trading links with the continent. However, news of further job creation assuaged concerns and suggested that UK growth remains resilient.

- Quarter 4 2014 - With the UK economy on a surer footing, the recovery in UK commercial real estate continued to broaden out. In performance terms, the sector recorded a strong total return for 2014, driven mainly by gains in capital values and a competitive investment market. Having initially been led by London, rental growth also improved in most sectors. Rents in the industrials sector strengthened further on improved tenant demand and a lack of stock. The retail sector still lagged behind as it continued to undergo structural changes. However, there was some emerging evidence that retail rents were beginning to stabilise, helped by the improving financial position of consumers. In terms of the investment market, interest in UK real estate showed no signs of abating and remained broad-based, with overseas investors, UK institutions and private companies all very active in the sector.

- Quarter 1 2015 - The investment market remained strong during the quarter, with overseas investors, UK institutions and private companies continuing to display a huge appetite for real estate assets. The focus remained on well-let assets in prime locations, namely central London, where bidding was competitive and prime assets were hotly contested. Given the ongoing shortage of available stock, some investors had no choice but to move up the risk curve and consider acquiring good-quality secondary assets in strong markets, often with repositioning or asset management opportunities. Investors also began to look more favourably on the real estate alternatives sector, which includes leisure, hotels and student accommodation.

- After a robust finish to last year, UK commercial real estate has made a relatively steady start to 2015, with prices maintaining reasonable acceleration and rents gathering further momentum. In a favourable environment of improving confidence among both businesses and consumers, UK real estate remains well positioned given its relatively high yield and improving income growth prospects. Relative to longer term government bonds, the yield gap remains significant by historic standards. In terms of outlook, managers continue to expect positive total returns for investors over a three-year period due to the strong income component and modest further capital appreciation. They expect locational choices to be the defining characteristics, contributing to returns over the remainder of the year. Prime/good quality secondary assets and selective poorer-quality secondary assets in stronger locations are likely to provide the best opportunities in the robust economic environment we anticipate over the course of 2015.

4 Investment Performance

4.1 The table below sets out the annualised performance of the Fund's current UK Commercial Property Investments over 1, 3, and 5 years and since inception. The IPD UK Pooled Property Funds Index All Balanced Fund Median is used to compare the managers' performance. This index was developed for all the leading managers of balanced property funds. The returns reported are taken from the published performance data. The transfer of Rreef portfolio to Blackrock took place in December 2012 so we currently have no since inception performance figures to report. The 2014/15 3 years annualised and 5 years annualised figures for Blackrock relate to the pooled fund and are not specific to Lincolnshire Pension Fund.

UK Commercial Property Investment returns to 31st March 2015

	2014/2015 %	**3 years Annualised %**	**5 years Annualised %**
Aviva	14.9	7.8	7.2
Royal London	13.5	8.4	8.2
Blackrock	14.6	9.1	8.2
Standard Life	16.6	9.9	8.4
IPD UK PPFI All Balanced Median return	16.6	9.4	8.4

Inception dates are: Aviva – June 1993, Royal London – July 1991, Blackrock – December 2012, Standard Life – June 1993

4.2 Aviva underperformed the benchmark over one year having delivered 14.9% against a benchmark return of 16.6%. Over the last twelve months the fund has completed a number of asset purchases and sales. In accordance with the fund strategy purchases have been focused on core-plus/value-add assets that present the opportunity to generate performance by harnessing the cyclical upswing in the occupational market through asset management, refurbishment and development. The sales have been focussed on assets that have underperformed and that no longer meet the fund strategy. As a result the transactions costs incurred have held back returns over the period. The fund's overweight position to cash has also held back returns over the 12 months. The benchmark cash position during Q4 was between 5% and 6% and therefore the overweight cash position diluted the direct property performance over the quarter. During the first quarter of this year there were no transaction costs and the cash position was neutral to performance. The fund's income return is now broadly in line with benchmark so the underperformance was due to a below benchmark capital return. Whilst there was asset management activity during the quarter that contributed to the fund's capital return, it was generally focused on smaller initiatives rather than the larger projects that have the potential to materially affect the fund's performance. Importantly, good progress was made with these larger projects so we expect them to deliver performance later this year but the lack of significant added value from asset management was the main driver of underperformance.

4.3 RLAM returns were not as strong as they would have liked them to be, but the Fund is well-positioned in the short to medium term for improved levels of performance. Throughout 2014 and into this year, the Fund has been placing a new allocation of investor money into the market as well as working through a number of asset management initiatives across various properties. Consequently, the Fund has incurred higher levels of costs than normal as well as consciously running a void rate higher than the benchmark in the short term. However, the properties that have been acquired offer good future growth opportunities and investors will benefit from these going forward as well as from the returns now coming through further to certain asset management initiatives having been completed.

As at 31 March 2015 the void rate of the Fund was 12.6% (16.1% as at 31 December 2014), compared with a benchmark figure of 7.2%. The overall Fund void is spread across a number of properties and isn't concentrated in only one or two. The void rate continues to fall and two properties containing a degree of void, Glencairn Industrial Estate, Kilmarnock & 2 Soho Square, London, have been sold ahead of valuation during Q2 2015. The Fund is also successfully letting up the newly completed industrial business park that it acquired in Chessington last year. This will further reduce the void level and increase levels of performance.

The Fund is generally invested at the prime end of the market and the property portfolio is of good quality. It is balanced across the UK, with a substantial focus on the south-east of England. Consequently, the income return is marginally lower to reflect the quality of the occupational tenants and properties. While there has been yield compression at the prime end of the market, the significant yield movement has been seen at the more volatile secondary end of the market. Secondary properties generally provide a higher income return to reflect the riskier nature of the income secured against them. While market conditions remain strong, this most likely won't always be so. Prime properties in core locations will usually provide more stable and robust returns in times of market fluctuations.

4.4 The Standard Life Fund matched the benchmark over the year and is ahead of the benchmark of three years but trails over five years and since inception. The office and industrial sectors again drove portfolio performance. All other segments underperformed against the Fund level return, particularly the supermarket holdings, which saw negative capital growth over the quarter in line with the market as a whole. The provincial office portfolio produced the highest total returns, with the development at St Andrew Square, Edinburgh, benefiting from improved rental values and further yield compression on the office element. The South East industrial portfolio also delivered strong total returns at just under 4%, primarily because of the level of income return and further yield compression. Standard Life believe the Fund currently remains well structured and they will continue to pursue their strategy of improving the overall quality and duration of the Fund's income stream. They balance this approach with acquiring opportunities where they can add value through asset management and / or stock selection.

4.5 The Blackrock Fund delivered a return of 14.6% for the 12 months compared to the benchmark return of 16.6%. The Fund continues to underperform the benchmark over three and five year periods. The long term objective of the Fund is to outperform the average of similar institutional pooled vehicles by investing in a diversified range of property throughout the UK, principally, but not exclusively, in the retail, office and industrial sectors. The Fund ended the year with 102 assets, delivering an income yield of 3.9%.

4.6 During the year the property benchmark was changed to show the split between UK Commercial Property Unit Trusts and Property Venture investments. The UK Commercial Property Unit Trusts maintained the benchmark of the IPD UK All Balanced Median Return and the Property Venture holdings benchmark was set at 7% per year. The overall return in the year for UK Commercial Property was 14.73% against a benchmark of 16.6%, whilst the return for Property Ventures for 9.79% against the benchmark of 7%. The return for property combined was 13.06% against the combined benchmark of 13.64%.

5 PROPERTY VENTURES

5.1 To diversify from the UK core property market, investments have been made in a number of different types of property funds aiming, over the long term, to exceed conventional market returns through specialist and active involvement in different parts of the property market. The four Funds have limited lives of between seven and ten years, over which time they will try to invest in specific projects to improve their value and then realise the profits through sales and the return of capital to investors. The commitments for these funds are generally drawn down over three to five years, and for some investments, it is too early to report meaningfully on performance. Comments on the initial activity are set out below.

5.2 **RREEF Ventures III Unit Trust**

The Committee approved the commitment of £10m in January 2006 and this has now been fully drawn down to fund a number of projects, some of which have now been realised. The value of the Fund's units at 31st March 2015 was £2.9m. The Fund continues to be wound up and at the end of the year owned six assets, with two sales that should complete shortly. The management continue to work through the asset management plans and as these are completed the properties will be sold.

5.3 **Franklin Templeton European Real Estate Fund of Funds – Luxembourg public limited company**

The Committee approved the investment in October 2005 of €15m. So far this Fund of Funds has made commitments to eleven underlying funds, including a portfolio of German nursing homes, a specialist French property investor, a UK real estate partnership, a pan European real estate fund and a German commercial property investor. At this stage the Fund's investment is valued at the £3.1m, but the valuation of the underlying funds is as at a terminal valuation, and therefore very prudent.

5.4 **Franklin Templeton Asian Real Estate Fund of Funds – Luxembourg public limited company**

The Committee approved the investment in October 2007 of $25m. The Fund has made a total of sixteen investments at this stage and has drawdown 97% of the Fund's total commitments. The value of the Pension Funds investment is £8.3m at 31st March 2015. Total distributions are 69% of total commitments to date. Managers are pleased with the portfolio assembled and the progress that has been achieved to date.

5.5 **Igloo Regeneration Partnership**

The Committee approved the commitment of £10m in April 2006 to a partnership with a pipeline of early stage regeneration projects in the UK. The partnership produced a return of 15.4% over the twelve months ended March 2015, behind the IPD benchmark of 18.32%. The Pension Fund's investment value is £5.1m at 31st March 2015. The Igloo Fund has undertaken a thorough review of its strategy from 2014 to 2018 (5 years). The Fund's Business Plan is to target the delivery of 13% per annum returns over the remaining Fund term through the realisation of investment asset sales and development of nearly 800 homes and 100,000 sq ft of commercial space.

6 **EUROPEAN BALANCED PROPERTY FUND**

6.1 **Standard Life European Property Growth Fund – Unit Trust**

To diversify the Fund's balanced property exposure, a commitment of €5m was made in November 2002 to a new pooled investment vehicle created by Standard Life to invest in Continental European property. A further commitment of €10m was approved to the European Property Growth Fund in July 2005. As at the 31st March 2014, this commitment had been fully drawn and the investment in the Fund was valued at £8.7m The Fund owns office, retail and distribution properties in France, Spain, Belgium, Portugal, Hungary, Germany, Poland, Sweden and the Czech Republic. Over the twelve months ended 31st December 2014, the European Fund produced a return (after costs), in euro terms, of 3.06%, with an annualised performance since inception of 3.3%. The strategy remains to continue to reposition the Fund's portfolio to capture future growth by increasing the Fund's exposure to both stronger and recovering economies, focusing on asset management initiatives which increase income yield over the medium term, lengthen the term of secured income, reduce vacancies, and improve income covenants and portfolio quality.

7 INFRASTRUCTURE

The Fund has made commitments to funds managed by a specialist investor in Private Finance Initiative and similar projects, both in the UK and overseas. The investments offer prospective long term indexed returns in excess of those available from bonds. There is potential for improved returns from refinancing opportunities and contract variations. Whilst the investments hold equity stakes in the ownership and operation of large capital projects, they are not property investments in the strictest sense. The long-term nature of these investments fits well with the investment perspective of a pension fund.

7.2 Innisfree Continuation Fund II – partnership

The Committee approved a commitment of £8m to the Innisfree Continuation Fund II in January 2006. Following the Fund's acquisition of assets from an earlier Innisfree primary fund, and the subsequent follow on investments in Arrow Light Rail (2008), Sheffield Schools and MOD Main Building (2009), the Dutch High Speed Rail Link and West Berks Hospital (2011) and Derby Hospital and Walsgrave Hospital (2012); and the disposal of the Arrow Light Rail in December 2011. Fund 2C now has a total of £337m committed to 12 project investments, all of which are operational. From inception, the Fund's portfolio of investments has generated returns that are over 29% higher than was anticipated in the base case acquisition model, and investors have received an average net yield of 8.9%.

The investment is currently valued at £7.6m. The forecast long-term gross IRR of the portfolio is 10.9%, compared to the base case of 8.75%.

7.3 Innisfree Secondary Fund (ISF) - partnership

The Committee approved a commitment of £15m to the Innisfree Secondary Fund in July 2007. Secondary Funds are long term holders of PPP (public/private partnerships) and PFI projects which have typically reached their operating stage. Returns to investors are principally by way of cash generated by the projects during the remainder of their concession lives. ISF had its final closing on 30 June 2008, taking aggregate commitments to £600.5m, with 21 limited partners. As at 31st March 2015 the Fund had total commitments of £585.3m to 34 projects. The Fund is 98% committed to investments and around 89% of investor commitments have been cash drawn.

The investment is currently valued at £13.7m. The current investment IRR is 14.6% compared to a base case of 10.5% and the forecast 10 year average yield is 10.9%.

7.4 **Innisfree Secondary Fund 2 (ISF2) - partnership**

The Committee approved a commitment of £10m to the Innisfree Secondary Fund 2 in January 2013. ISF2 had its final closing on 31st March 2013, taking aggregate commitments to £544m, with 11 limited partners. The Fund was 70% committed to investments and 67% of investor commitment had been cash drawn at 31st March 2015.

ISF2 was the other fund that bought the assets of Innisfree Fund III, acquiring 68% of each Fund III investment. This portfolio is forecast to provide a gross to fund purchase IRR of 10.5% and a ten year average yield of 9.2%.

Conclusion

8.1 Overall, the Pension Fund's investment in property and infrastructure generated a good return of 13.06%, which was behind the benchmark (as measured by JPMorgan) return of +13.64%. The property allocation, at 11%, was less than its benchmark allocation of 11.5%, with a further £7.7m in undrawn commitments.

8.2 The performance since inception, which is not directly comparable due to different start dates, shows that good long term returns have been achieved by most of the Funds, at over 7% per annum.

Consultation

a) Policy Proofing Actions Required

n/a

Appendices

These are listed below and attached at the back of the report

Appendix A	UK Balanced Property Allocation at 31st March 2015

Background Papers

No background papers within Section 100D of the Local Government Act 1972 were used in the preparation of this report.

This report was written by Nick Rouse, who can be contacted on 01522 553641 or nick.rouse@lincolnshire.gov.uk.

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