Regulatory and Other Committee

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

Report to:	**Pensions Committee**
Date:	**14 July 2016**
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 2016.

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 2016 was £199.3m (11.5% 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 2016

Property Pooled Investment Vehicle	Undrawn Commitments 31/3/16 £m	Market value of LCC holdings 31/3/16 £m

BALANCED UK PROPERTY		
Aviva Pooled Property Fund	n/a	41.8
Royal London Exempt Unit Trust	n/a	21.2
Blackrock – UK Property Unit Trust	n/a	20.4
Standard Life - Trustee Investment Plan	n/a	62.2
Total UK Commercial Property		**145.6**
PROPERTY VENTURES		
RREEF – Property Ventures Fund III	0.0	3.2
Franklin Templeton European Fund of Funds	0.4	2.3
Franklin Templeton Asian Fund of Funds	3.1	6.5
Igloo Regeneration partnership	0.0	4.4
Total Property Ventures	**3.5**	**16.4**
EUROPEAN COMMERCIAL PROPERTY		
Standard Life European Growth Fund	0.0	9.9
INFRASTRUCTURE		
Innisfree PFI Continuation Fund II	0.2	7.2
Innisfree PFI Secondary Fund	1.3	13.4
Innisfree PFI Secondary Fund 2	2.5	6.8
Total Infrastructure	**4.0**	**27.4**
TOTAL PROPERTY	**7.5**	**199.3**

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, Industrials in the South East, Offices in London and cash. The Fund is underweight Standard Retail, Offices in the South East and the rest of the UK, the Industrial sector in the rest of the UK and the "Other" sector (this includes properties such as leisure and residential and listed assets).

Overall UK property sector asset weightings at 31st March 2016

Property Sector	LCC Fund %	IPD %	Difference %
Retail	35.4	32.4	3.0
Offices	34.2	34.0	0.2
Industrial	19.0	20.8	(1.8)
Other	11.4	12.8	(1.4)
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 South East and the rest of the UK. Underweight positions are underweight Industrial in the rest of the UK and "other" properties.

- Blackrock is overweight Retail Warehouses and heavily overweight Other Properties. They are underweight in Standard Retail and Offices in the South East 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 10.6% (IPD index), over the twelve months to 31st March 2016, compared to UK equity returns of -3.9% (FTSE All Share) and UK index-linked bond returns of 8.8%.

- Quarter 2 2015 – Total returns from UK commercial real estate moderated further during the second quarter but remained well ahead of their long term average. Slowing capital growth was the main contributor to the moderation in returns, with capital values increasing by 10.3% p.a. over the year compared to 11.6% p.a. in the previous quarter.

- Quarter 3 2015 - UK commercial real estate returns maintained their positive but moderating momentum, supported by the relatively strong UK economy. Prime yields fell further over the period, moving closer to their previous peak in 2007, with the most noticeable compression in certain office and industrial sub-sectors. While the retail sector generally continued to lag, there were tentative signs of improvement here also, with rental growth starting to materialise. As money flowed into commercial real estate, forcing up prices, investors continued to search beyond London and into the regions for opportunities. Indeed, Savills estimated that nearly 60% of investment activity last year took place outside the capital.

- Quarter 4 2015 - Returns from UK commercial real estate continued to moderate during the review period. A dip in capital value growth for the fourth consecutive month was the main reason behind the fall, while rental growth generally remained steady. At a sector level, industrials and offices, particularly in the City of London, continued to lead the way. Retail remained the weakest sector, but there was some optimism as shopping centres experienced the biggest month-on-month uplift in returns of any market segment.

- Quarter 1 2016 - Returns from UK commercial real estate moderated further during Q1, with capital value growth reducing for the seventh consecutive month. Rental growth generally remained positive because of strong occupier markets, where many tenants were looking to commit for the long term or seeking additional space. From an investment perspective, volumes were 25% lower in January and February than the previous year, as investors waited for the outcome of the EU referendum.

4 Investment Performance

4.1 The table below sets out the annualised performance of the Fund's current UK Commercial Property Investments over one, three and five 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 the Rreef portfolio to Blackrock took place in December 2012 so there is no since inception performance figures to report. The five 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 2016

	2015/2016 %	**3 years Annualised %**	**5 years Annualised %**
Aviva	9.7	12.0	7.5
Royal London	9.1	11.4	8.3
Blackrock	9.6	11.9	8.3
Standard Life	9.4	12.5	8.4
IPD UK PPFI All Balanced Median return	10.6	13.3	9.0

4.2 Aviva underperformed the benchmark over one year having delivered 9.7% against a benchmark return of 10.6%. Over the last twelve months, the fund has completed a number of sales and limited purchases. 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 focused on assets that have underperformed and that no longer meet the fund strategy. The volume of sales throughout the year has increased the cash position of the fund above the benchmark level for the later part of 2015 and the early part of 2016. This has been a drag on the relative performance of the fund during this period. The fund's supermarket assets dragged performance in 2015 as values were written down due to occupational issues in the grocery market. Expansion and store openings have all but ceased and the reduction of occupational demand has fed through to rental values and expectations of rental growth. This in turn has impacted the investment market with fewer purchasers for supermarket assets and poor sentiment around the tenant covenants, feeding through to pricing of assets and valuations. The Aviva fund intends to dispose of two supermarket assets in 2016, which should mitigate the impact of the weakening retail environment on the portfolio.

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. Void levels have continued to impact on performance. As at 31 March 2016 the void rate of the Fund was 12% (12.6% as at 31 March 2015), compared with a benchmark figure of 7.1%. 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 is behind the benchmark over all periods. The office and industrial sectors again drove portfolio performance. The Fund's higher weighting to the retail sector, and in particular its heavy weighting in shopping centres and supermarkets, has had the most significant impact on performance over the last year. The underweight exposure to South East offices, which has been one of the best performing segments of the market recently, has also dragged on performance over this time period. The Standard Life Fund is one of the largest pooled funds in the UK and is well diversified across sectors and geographic regions.

4.5 The Blackrock Fund delivered a return of 9.6% for the 12 months compared to the benchmark return of 10.6%. The Fund continues to underperform the benchmark over three and five year periods. During the year Blackrock have taken active decisions to reposition the Fund where appropriate. They have decided however to hold one particular investment, their portfolio of doctor's surgeries, despite its relative underperformance. This is due to their expectation that the investment will perform strongly in the market environment they expect to enter. The cost of re-positioning a property portfolio is significant, due mainly to stamp duty imposed on any purchase. Combined with agency and legal fees, the total cost of divesting then reinvesting is approximately 6.5%. 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.

4.6 During 2014/15 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 9.13% against a benchmark of 10.6%, whilst the return for Property Ventures for 9.06% against the benchmark of 7%. The return for property combined was 9.11% against the combined benchmark of 9.52%.

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 (before extensions), 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 2016 was £3.2m. The Fund continues to be wound up and 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 £2.3m, but the valuation of the underlying funds is as at a terminal valuation, and therefore very prudent. The since inception Internal Rate of Return was -7.18% at 31 March 2016.

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 £6.5m at 31st March 2016. Total distributions are 81% of total commitments to date. Managers are pleased with the portfolio assembled and the progress that has been achieved to date. The since inception Internal Rate of Return was 2.19% at 31 March 2016.

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 11.5% over the twelve months ended March 2016, behind the IPD benchmark of 14%. The Pension Fund's investment value is £4.4m at 31st March 2016. The Igloo Fund has undertaken a thorough review of its strategy from 2014 to 2018 (five years). The Fund's Business Plan is to target the delivery of 13% per annum returns. The Fund is focused on the regeneration and repositioning of ten key locations across the UK, delivering developments with market leading levels of high quality, sustainable design.

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 2016, this commitment had been fully drawn and the investment in the Fund was valued at £9.9m 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 2015, the European Fund produced a return (after costs), in euro terms, of 4.6%, with an annualised performance since inception of 3.5%. 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 30% higher than was anticipated in the base case acquisition model, and investors have received an average net yield of 9.1%.

During the year the Pension Fund and two other existing investors purchased the investor commitment of BAE Systems Pension Fund. The total sale price was £21.8m with the proportion Lincolnshire Pension Fund being able to purchase was £539,000.

The investment is currently valued at £7.2m. The forecast long-term gross IRR of the portfolio is 11.3%, 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 18 limited partners. As at 31st March 2016, the Fund had total commitments of £578.3m to 34 projects. The Fund is 98% committed to investments and around 90% of investor commitments have been cash drawn.

During the year the Pension Fund and two other existing investors purchased the investor commitment of BAE Systems Pension Fund. The total sale price was £59.4m with the proportion Lincolnshire Pension Fund being able to purchase was £1,500,000.

The investment is currently valued at £6.8m. The forecast long-term gross IRR of the portfolio is 10.8%, compared to the base case of 10.5%.

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 68% committed to investments and 67% of investor commitment had been cash drawn at 31st March 2016.

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 10.8% and a ten year average yield of 10.3%.

Conclusion

8.1 Overall, the Pension Fund's investment in property and infrastructure generated a good absolute return of 9.11%, which was behind the benchmark (as measured by JPMorgan) return of +9.52%. The property allocation, at 11.5%, matched the benchmark allocation, with a further £7.5m 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 2016

Background Papers

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

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