Regulatory and Other Committee

| Open Report on behalf of Executive Director of Finance and Public Protection |
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| Report to: | **Pensions Committee** |
| Date: | **13th July 2017** |
| Subject: | **Annual Report on the Fund's Property and Infrastructure Investments** |

**Summary:**

This report outlines the performance of the Fund's property and infrastructure investments for the year ended 31st March 2017.

**Recommendation(s):**

That the committee note the report.

## Background

### 1 Introduction

1.1 Investment exposure to property and infrastructure is achieved via holdings in pooled vehicles. The Fund's strategic allocation of 9% to property is slightly higher than the average local authority pension fund, currently at 8%. The market value of holdings in property pooled vehicles at 31st March 2017 was £187m (8.9% of the Fund). Whilst the majority of exposure is to UK commercial property, to diversify the property allocation the Fund made commitments to European commercial property, property venture type funds and Asian commercial property. The Fund has a 2.5% strategic allocation to infrastructure and has made commitments to Private Finance Infrastructure schemes. The market value of holdings in infrastructure pooled vehicles at 31st March 2017 was £31.4m (1.5% of the Fund).

**Market value of property and other holdings at 31 March 2017**

| Property Pooled Investment Vehicle | Undrawn Commitments 31/3/17 £m | Market value of LCC holdings 31/3/17 £m |
|---|---|---|
| **BALANCED UK PROPERTY** | | |
| Aviva Pooled Property Fund | n/a | 41.7 |
| Royal London Exempt Unit Trust | n/a | 22.0 |

| | | |
|---|---|---|
| Blackrock – UK Property Unit Trust | n/a | 39.0 |
| Standard Life - Trustee Investment Plan | n/a | 58.8 |
| **Total UK Commercial Property** | | **161.5** |
| | | |
| **PROPERTY VENTURES** | | |
| RREEF – Property Ventures Fund III | 0 | 2.4 |
| Franklin Templeton European Fund of Funds | 0.3 | 1.5 |
| Franklin Templeton Asian Fund of Funds | 3.3 | 6.5 |
| Igloo Regeneration partnership | 0 | 4.0 |
| **Total Property Ventures** | **3.6** | **14.4** |
| | | |
| **EUROPEAN COMMERCIAL PROPERTY** | | |
| Standard Life European Growth Fund | 0 | 11.1 |
| | | |
| **INFRASTRUCTURE** | | |
| Innisfree PFI Continuation Fund II | 0.3 | 8.2 |
| Innisfree PFI Secondary Fund | 0.3 | 16.3 |
| Innisfree PFI Secondary Fund 2 | 2.4 | 6.9 |
| **Total Infrastructure** | **3.0** | **31.4** |
| | | |
| **Property/Infrastructure Cash** | | **7.6** |
| | | |
| **TOTAL PROPERTY AND INFRASTRUCTURE** | **6.6** | **226.0** |

## 2 Balanced UK Commercial Property

2.1 During the year income from the holdings was reinvested and an additional £15m was invested in Blackrock's Fund. 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 2017

| Property Sector | LCC Fund % | IPD % | Difference % |
|---|---|---|---|
| Retail | 33.3 | 30.9 | 2.4 |
| Offices | 31.6 | 30.6 | 1.0 |
| Industrial | 50.5 | 22.2 | (1.7) |
| Other | 14.6 | 16.3 | (1.7) |
| | | | |
| 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 industrial sector in the rest of the UK, and no allocation to shopping centres. Property sizes are generally smaller when compared to the other managers.

- Aviva also has no allocation to shopping centres but is overweight standard retail, retail warehouses, offices in London and the south east and industrials in the south east. They are underweight in offices in the rest of south east and industrials 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 shopping centres and significantly so in offices in London, and underweight other property, industrials in the rest of the UK and offices in the south east and rest of UK.

## 3 Market Environment in the Period Reported

- Property produced total returns of 3.8% (IPD index), over the twelve months to 31st March 2017, compared to UK equity returns of 22% (FTSE All Share) and UK index-linked bond returns of 19.9%.

- Quarter 2 2016 – The result of the referendum on EU membership on June 24th created considerable uncertainty, particularly in relation to the role of London once it is outside of the EU. In the UK, Sterling fell sharply in value and sovereign bond yields fell as markets expect weaker economic growth both in the UK and across Europe. A key driver of lower economic growth for the future is expected to be a reduction in business investment as companies hold off making large investment decisions until the impact of Brexit becomes clear. The impact of this uncertainty fell disproportionately on banks and listed real estate companies that had a large proportion of their assets in London.

- Quarter 3 2016 - The third quarter of 2016 was a turbulent one for UK real estate after the surprise referendum result. Sharp falls in listed real estate company prices were followed by the suspension of redemptions from a number of daily priced open ended property funds. However, over the course of the quarter the impact on the listed market moderated and many of the funds which had suspended opened once again trading normally. Overall values were down by 4.0% over the third quarter, however the impact was not uniform. City of London offices were hit hardest, with values down by 7.4%. The strongest performing sectors were industrial properties and alternatives (a mix of various property types including student accommodation, healthcare, leisure, hotels and residential). Transaction activity weakened further in the third quarter despite a spike in activity from open ended funds generating liquidity to pay redemptions.

- Quarter 4 2016 - The UK property market proved to be far more resilient than many commentators expected in the fourth quarter of 2016. Partly this was the result of the economy performing better than expected, but also continued strong investor demand for real estate assets, driven by the relatively attractive yield offered and the decline in Sterling attracting international capital. Across the market as a whole values rose by just over 1%, in large part due to the health of the industrial investment and occupational market where values rose by just under 4%. In Central London, where many expected the impact of the vote to leave the EU would be greatest, resurgent overseas investor demand underpinned the value of prime office and retail assets. However, outside of prime assets, there were signs that the performance of Central London properties were beginning to falter; retail occupiers in particular are having to absorb the impact of significant rises in business rates. Since the vote to leave the EU, industrial and alternative real estate investments (such as student accommodation, healthcare and hotels) continued to prove to be more robust than those in the retail and office sectors.

- Quarter 1 2017 - The UK commercial property market remained resilient in the first quarter of 2017. In the Central London office market, weak occupier demand was offset by strong demand from overseas investors, particularly Chinese buyers seeking to get Yuan denominated capital invested in a perceived safe haven, where the decline in Sterling offers an upfront effective c.15% discount, in Sterling depreciation alone. These buyers dominated investment activity in the first quarter with a small number of large deals. Outside of these large prime transactions to overseas investors, activity in the Central London office market remained relatively muted and the pricing of these smaller generally older and shorter leased buildings less certain. Domestic institutional investors were also returning to the market, although their activity focused with industrial/logistics properties and alternatives particularly in demand. The retail sector, as a whole, continued to face significant headwinds as higher import costs, rising wages and local taxes together with the continued growth of internet sales impact on profitability. Alternative investments continued to see strong investor appetite especially those with long leases and fixed or inflation linked rents reviews.

## 4 Outlook

- After surprising on the upside in the latter half of last year, the UK economy appears to be showing some signs of slowing momentum. The economy is still expanding though, with most output indicators pointing towards GDP growth of around 0.5% for the quarter. In simplistic terms, a resilient economy should be supportive for the fundamentals of the property market. Firstly by reinforcing investor sentiment towards the asset class and crucially by underpinning the demand of business occupiers, thus sustaining rental levels. However, a number of risks remain and cannot be overlooked.

- To date, the most prevalent and lasting effect of Brexit has been the devaluation of sterling. For example, in US dollar terms, the pound is around 12% cheaper than it was 12 months ago. This movement has helped support the UK property values by attracting overseas capital and investors back into the market. Pricing across the entire market, which suffered downward pressure last year, has recovered in the main, with six consecutive months of positive capital growth. There has been a shortage of prime quality stock and renewed confidence from both domestic and foreign investors has led to some very competitive recent bidding.

- Uncertainty surrounding the UK government's negotiating position with the EU remains a significant risk to the medium term outlook, but occupier demand for space is not expected to collapse in the near term. On the whole, the occupier market remains relatively stable, albeit with some divergence beginning to show across the main sectors. There has been an expected softening in headline rents in City and West End office markets, but vacancy rates are still low by historic standards. Conversely, the South East industrial market, aided by constrained supply, continues to see evidence of strong rental growth.

- In summary, it is expected that income will be the main component of total returns over next few years. Global allocations to real estate as at asset class continue to increase. Continuing demand from overseas investors for "safe haven" status, coupled with a low interest rate environment should sustain UK property yields around their current levels.

## 5 Investment Performance

5.1 The table below sets out the annualised performance of the Fund's current UK Commercial Property Investments over one, three, five and ten years. The IPD UK All Balanced Property Funds Index 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 five and ten 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 2017**

| | 2016/2017<br>% | 3 years Annualised<br>% | 5 years Annualised<br>% | 10 years Annualised<br>% |
|---|---|---|---|---|
| Aviva | (0.3) | 7.9 | 6.5 | 1.8 |
| Royal London | 3.7 | 8.7 | 7.6 | 3.9 |
| Blackrock | 3.5 | 9.2 | 8.1 | 2.1 |
| Standard Life | 1.6 | 9.0 | 7.8 | 2.1 |
| IPD UK PPFI All Balanced Median return | 3.7 | 10.2 | 8.5 | 2.1 |

5.2 Aviva underperformed the benchmark over one year having fallen by 0.3% against a benchmark return of +3.7%%. The Fund has had a disappointing return over all periods. The manager changes in September sought to address this, however performance is still lagging the benchmark as managers reposition the portfolio. The Fund has been profitably disposing of non-core assets and focusing investment into sectors and locations where they have conviction in the long term performance prospects. They remain value focused, investing in assets where they see opportunities to unlock or create value, where market pricing is attractive relative to intrinsic value and where returns adequately compensate for the risks being taken. In addition, the Fund continues to dispose of assets they have identified as non-performing properties not aligned with the Fund's investment strategy.

5.3 RLAM returns matched the benchmark return over the year, and is well ahead over the ten year period. Void levels have been reduced over the year, from 12% to 6.9%, below the benchmark rate of 7.7%. This has positively impacted on performance. RLAM's aim is to balance the income from the core holdings with more active management on those properties that will benefit from refurbishment or development. They consider the location of a property as the primary consideration. Once the fund manager is satisfied on this aspect, they then incorporate economic factors and determine the overall sector allocation to retail, industrial or office sectors.

5.4 The Standard Life Fund is behind the benchmark over all periods, other than ten years, where it has matched the benchmark. The key factors in the underperformance were the overweight position in Central London offices, which were impacted the most by the uncertainty surrounding the EU referendum result, and the larger asset sizes which are predominant within the Fund, which had generally been marked down more significantly than smaller assets. This was as a result of reduced levels of liquidity for these properties in the post-Brexit environment. This was particularly true in the retail and Central London holdings, where the Fund is significantly overweight. The Standard Life Fund is one of the largest pooled funds in the UK and is well diversified across sectors and geographic regions. The fund aims to provide long term growth from a combination of income and capital growth by investing predominantly in prime quality UK properties.

5.5 The Blackrock Fund is slightly behind the benchmark performance over all periods other than ten years, where it is matching the benchmark. The repositioning that has been undertaken over the last two years, causing a drag on performance, has now been completed. The team will now be focussing on successfully delivering the current development projects within the Fund, and engineering capital value growth and income security through a focus on asset management. The Fund's core investment strategies are in primary healthcare, student accommodation, multi-let industrials and logistics warehouse development. The manager is confident that the assets the Fund holds are high quality and offer significant opportunity to drive additional income and performance through the delivery of asset management initiatives.

5.6 The UK Commercial Property Unit Trusts have a benchmark of the IPD UK All Balanced Median Return and the Property Venture holdings benchmark is set at 7% per year. The overall return in the year, for the combined property and infrastructure allocation, was 4.95% against a benchmark return of 4.8%, therefore the under performance of the core UK commercial Funds was offset by the venture and infrastructure returns.

## 6 PROPERTY VENTURES

6.1 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.

6.2 **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, most of which have now been realised. The value of the Fund’s units at 31st March 2017 was £2.4m. Unfortunately this investment was made before the financial crisis of 2008, and all property purchases were made in 2006 and 2007, ahead of the large fall in property asset values. The Fund continues to be wound up and the management continue to work through the asset management plans of the final two properties, and as these are completed the properties will be sold. Total distributions since inception to 31st March 2017 are £850k, with an additional £2.3m distributed in May this year. The year end investment multiple (the value plus the distributions received, divided by the total capital committed) is 0.3.

**6.3 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 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. During the year, the Fund continued the disposition of its investments. On a cumulative basis, 64.0% of the aggregated invested capital has been returned by the underlying Real Estate Funds. At this stage the Fund's investment is valued at the £1.5m, but the valuation of the underlying funds is as at a terminal valuation, and therefore very prudent. Since inception £6.3m has been distributed, and the year end investment multiple was 0.6%, with an internal rate of return of -6.7%.

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

The Committee approved the investment in October 2007 of $25m, with $4m left to be drawn down as at 31st March 2017. The Fund made a total of sixteen investments, and at this stage five Funds have fully completed the disposition of their assets, and another three are close to full realisation. The value of the Pension Funds investment is £6.5m at 31st March 2017, but the valuation of the underlying funds is as at a terminal valuation, and therefore very prudent. Since inception £10.1m has been distributed, and the year end investment multiple was 1.1%, with an internal rate of return of 1.3%. Managers are pleased with the portfolio assembled and the progress that has been achieved to date.

6.5 **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 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. The partnership produced a return of -11.2% over the twelve months ended March 2017, ahead of its benchmark of 5.5%. This performance figure includes the impact of a negative adjustment for the potential termination value of the investments, and an accrual of anticipated termination costs. The Pension Fund's investment value is £3.9m at 31st March 2017, having distributed £3.9m since inception, resulting in an investment multiple of 0.8. The Fund has a significant cash balance and proposals for the distribution of uncommitted elements will be detailed as part of the updated Fund Business Plan. Following engagement with all of the Fund's investors on the options for Fund over its remaining term to end-2018 an updated Business Plan and investment strategy is being finalised for distribution in Q3 2017.

In May this year, the Fund Manager circulated an "end of life initial proposal" to investors, offering two choices –

- Option 1 - Wind Up of the Partnership (whether by a sale of the Partnership/whole portfolio or a break up and sale of portfolio interests) as envisaged by the Partnership's constitutional documents; or

- Option 2 - Continuation / Extension

Investors holding approximately 98% of the issued units in the Partnership have confirmed their preference for the Partnership to be wound up. In the absence of all investors confirming that they are interested to pursue the continuation/extension Option 2, the Fund Manager is intending to proceed with the winding up of the Partnership when the Fund's term expires on 30 June 2017, in accordance with the Partnership's constitutional documents in its additional role as liquidating trustee. The Fund Manager is taking advice on the best way to maximise returns to investors in the Partnership's winding up and will keep investors informed on progress.

## 7 EUROPEAN BALANCED PROPERTY FUND

### 7.1 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. The Fund owns office, retail and distribution properties in France, Spain, Belgium, Portugal, Hungary, Germany, Poland, Sweden and the Czech Republic. As at the 31st March 2017, this commitment had been fully drawn and the investment in the Fund was valued at £11.1m. Distributions of £4.4m have been received, producing an investment multiple of 1.1. The Fund continues to monitor the market for any transactions that could boost performance, increase exposure to either the strongest or recovering markets, increase income security with strong covenant tenants, or improve portfolio quality. Managers are currently reviewing transactions across all sectors, with a main focus on income in the Netherlands, France, Germany, Spain and Central and Eastern Europe.

## 8 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. Officers are currently undertaking due diligence on a number of Infrastructure Funds, to increase the investment in this asset class.

**8.2 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), Derby Hospital and Walsgrave Hospital (2012), and Stoke and Rotherham Schools (2013); 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 2015/16, 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 £8.2m, having distributed £5.3m to 31st March 2017. The current investment multiple is 1.7, with an internal rate of return of 11.2%, and returns being 32% higher than the original estimated base case.

8.3 **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 2017, the Fund had total commitments of £575.7m to 33 projects, and around 95% of investor commitments have been cash drawn. Projects include schools, hospitals and MOD buildings.

During 2015/16, 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 £16.3m, having distributed £4.7m to 31st March 2017. The current investment multiple is 1.4, with an internal rate of return of 12.0%, and returns being 14% higher than the original estimated base case.

8.4 **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. The Fund is similar to ISF and is invested in projects including schools, hospitals and Thameslink,

ISF2 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%.

The investment is currently valued at £6.9m, with outstanding commitments of £2.4m, and having distributed £1.8m to 31st March 2017. Although still early on in the investment cycle, the current investment multiple is 1.2, with an internal rate of return of 11.0%.

**Conclusion**

9.1 Overall, the Pension Fund's investment in property and infrastructure generated a good absolute return of 4.95%, which was behind the benchmark (as measured by JPMorgan) return of 4.8%. The property allocation, at 9.3%, is slightly overweight its benchmark allocation, with 3.6% in undrawn commitments, and Infrastructure, at 1.5%, is underweight its benchmark allocation, with a further £3m in undrawn commitments.

**Consultation**

**a) Have Risks and Impact Analysis been carried out??**

Yes

**b) Risks and Impact Analysis**

The Pension Fund has a risk register which can be obtained by contacting the author of this report.

**Appendices**

| These are listed below and attached at the back of the report | |
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| Appendix A | UK Balanced Property Allocation – March 2017 |

**Background Papers**

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