Regulatory and Other Committee

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

Report to:	**Pensions Committee**
Date:	**19 July 2018**
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 31 March 2018.

Recommendation(s):

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 9.0% to property is slightly higher than the average local authority pension fund, currently at 7%. The market value of holdings in property pooled vehicles at 31 March 2018 was £207.5m (9.5% 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.

1.2 The Fund also 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 31 March 2018 was £35.5m (1.6% of the Fund).

1.3 The table over sets out the Fund's holdings as at 31 March 2018.

Market value of property and other holdings at 31 March 2018

Property Pooled Investment Vehicle	Undrawn Commitments 31/03/2018 £m	Market value of LCC holdings 31/03/2018 £m
BALANCED UK PROPERTY		
Aviva Pooled Property Fund	n/a	46.6
Royal London Exempt Unit Trust	n/a	23.5
Blackrock – UK Property Unit Trust	n/a	41.4
Aberdeen Standard - Trustee Investment Plan	n/a	64.0
Total Balanced UK Property	**n/a**	**175.5**
PROPERTY VENTURES		
RREEF – Property Ventures Fund III	0.0	0.5
Franklin Templeton European Fund of Funds	0.3	1.2
Franklin Templeton Asian Fund of Funds	4.0	2.7
Igloo Regeneration partnership	0.0	2.5
Total Property Ventures	**4.3**	**6.9**
EUROPEAN COMMERCIAL PROPERTY		
Aberdeen Standard European Growth Fund	**0.0**	**12.0**
INFRASTRUCTURE		
Innisfree PFI Continuation Fund II	0.5	8.2
Innisfree PFI Secondary Fund	1.4	16.6
Innisfree PFI Secondary Fund 2	1.7	7.7
Infracapital Greenfield Partners I	13.4	1.5
Pantheon Global Infrastructure III	18.9	1.5
Total Infrastructure	**35.9**	**35.5**
Property/Infrastructure Cash	**n/a**	**13.1**
TOTAL PROPERTY AND INFRASTRUCTURE	**40.2**	**243.0**

1.4 The performance of the property and infrastructure holdings during 2017/18 was: UK Commercial Property Unit Trusts return in the year saw an under performance of 8.70% against a benchmark of 10.05% and the return for Property Ventures was a significant under performance of -9.80% against the benchmark of 7.00%. This was partly offset by a significant over performance for infrastructure which gave a return of 16.89% against a benchmark of 6.00%. The overall return on the portfolio was a return of 8.11% compared to a benchmark performance of 8.91%.

1.5 Details of the individual property and infrastructure holdings and their performance are set out in the following sections of the reports.

2. BALANCED UK COMMERICAL PROPERTY

2.1 During the year income from the holdings was reinvested. 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. Offices 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, Industrials in the South East 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, residential and listed assets).

Overall UK property sector asset weightings at 31 March 2018

Property Sector	LCC Fund %	IPD %	Difference %
Retail	32.4	30.7	1.7
Offices	30.0	29.0	1.0
Industrial	24.3	26.0	-1.7
Other	13.3	14.3	-1.0
Total	**100.0**	**100.0**	

2.4 At an individual fund level:

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

- Royal London has a significant overweight position to standard retail and offices in London. They have no allocation to shopping centres. Property sizes are generally smaller when compared to the other managers.

- Blackrock is overweight retail warehouses and heavily overweight other properties. They are underweight in standard retail and offices in London and the south east.

- Aberdeen Standard is significantly overweight shopping centres and cash. It is also overweight in offices in London. It is underweight other property, industrials in the rest of the UK and offices in the south east.

3. Market Environment in the Period Reported

3.1 Property produced total returns of 11.3% (IPD index), over the twelve months to 31 March 2018, compared to UK equity returns of 1.2% (FTSE All Share) and UK index-linked bond returns of 1.0%.

3.2 Quarter 2 2017 The second quarter saw a continuation of the trends of the first quarter as UK commercial property markets clawed back more of the falls in value seen after the vote to leave the EU. Since the referendum, domestic investor activity was focused on industrial and logistics properties where values had risen significantly. Strong demand for Central London offices from overseas, particularly Chinese investors, helped to lift the value of this segment despite weakening tenant demand. Retail properties saw the weakest bounce back in values over the last 12 months. Prime shops in the larger regional centres performed better than the broader market, whereas secondary shopping centres remained out of favour. Alternative investment properties, such as primary healthcare and student accommodation, continued to deliver strong and stable returns underpinned by sustained rental growth. Across the UK as a whole development activity remained subdued, with the exception of Central London offices and industrial/logistics properties. In the former, vacancy had been increasing, whereas, the strength of tenant demand for industrial/logistics properties kept void rates for this sector low and driving continued rental growth.

3.3 Quarter 3 2017 The UK property market remained resilient in the third quarter of 2017 as demand for real estate assets, particularly from overseas investors, remained robust. However, there was considerable dispersion between the various parts of the market, where Central London shops, Industrials and Alternatives all recorded significantly higher values whilst the value of shopping Centres and out of town retail remained subdued. Transaction activity across Europe as a whole was down, with the focus moving away from the UK. That said, overseas investors remained active in the Central London office market, accounting for a record share of activity in the 3rd quarter. The Central London office market became increasingly polarised with large transactions dominating activity, with 20 transactions above £100 million vs just six in the same quarter a year ago. Domestic investors remained in the market for Industrial properties and Alternatives such as hotels, student accommodation and healthcare properties. Demand for long leased, indexed linked assets remained particularly strong, pushing up the prices of these assets.

3.4 Quarter 4 2017 UK commercial real estate delivered positive performance during the fourth quarter, concluding a relatively rewarding year for investors. Income returns remained strong, supported by robust occupational demand, while capital values also strengthened over the year. Investor appetite also remained strong and continued to be concentrated on ‘prime’ assets, including those with long income producing leases with the potential for strong rental growth. Whilst European real estate markets performed strongly in 2017, market data suggested the UK regained its title as the largest property investment market in Europe, supported by Asian capital flows. Demand for industrial assets was particularly buoyant, as favourable fundamentals and the security of long-lease income continued to attract investors. As a result, the sector delivered its best returns over the quarter and indeed the year. Political and structural headwinds remained; with Brexit, rising base rates and reduced consumer spending all potentially weighing on occupational activity, investment demand and property returns. However, there was optimism with positive momentum driven by a growth in lending, new capital sources, greater clarity over Chinese capital flows, and a broad based global economic recovery.

3.5 Quarter 1 2018 Following strong performance in 2017, UK commercial real estate delivered further modest capital growth in early 2018. However, there was a marked difference in performance between sectors. On a positive note, industrials continued to benefit from structural support for demand from e-commerce expansion and tight supply in urban areas. By contrast, the retail sector had a difficult start to the year, reflected in weak performance and limited investor interest in large-scale assets. The collapse of Toys R Us and Maplin, New Look's company voluntary agreement (CVA) and Carpetright's potential CVA all hit the headlines.

4. Outlook

4.1 It is expected that the return prospects for UK real estate, in aggregate, will weaken in the near term, as some of the factors underpinning the market turn gradually less favourable. The first of these is real estate's yield advantage over fixed-income assets which, though still very generous, has been shrinking in recent quarters as gilt yields move a little higher and real estate yields keep grinding lower. In addition, the deterioration in the occupier market overall, is expected to continue, in the face of a sluggish economic backdrop.

4.2 Industrial occupier markets are structurally well placed, but current rates of rental growth in the sector appear unsustainable. Coming quarters are likely to remain difficult for the consumer economy and for retail rents. Central London office rents meanwhile appear vulnerable to new supply and Brexit uncertainty, although occupational demand has remained robust in Q1.

4.3 Overall, the likelihood of a severe correction seems low, with yield driven investor demand for real estate set to remain robust in the low interest rate environment. In addition, indicators of occupier, development and lending conditions are relatively sanguine and suggest that market participants are behaving more conservatively than in previous cycles which should aid stability. The key downside risk to the market comes from the possibility of significantly higher interest rates in response to strong global economic growth.

5. Investment Performance

5.1 The table over 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 31 March 2018

	2017 / 2018 %	3 years Annualised %	5 years Annualised %	10 years Annualised %
Aviva	12.6	7.2	9.5	4.3
Royal London	6.8	6.5	8.9	5.1
Blackrock	9.9	7.6	9.8	4.3
Aberdeen Standard	8.7	6.5	9.5	4.3
IPD UK PPFI All Balanced Median return	10.0	8.1	10.5	4.4

5.2 Aviva has outperformed the benchmark over one year, delivering 12.6% against a benchmark return of 10.0%. Although in the longer term (3, 5 and 10 years) performance has been disappointing as it has been below the benchmark. Manager changes at the fund in September 2016 have begun to show improvements in performance with all three quarters up to March 2018 showing performance above the benchmark.

5.3 This fund focuses on: Income Growth – delivering growth in rental income through rent reviews, lease renewals, new lettings, repositioning assets and the creation of additional or higher value space; Income Quality – with desirable assets which attract and retain quality tenants; and Focused Strategy – investing in locations which will benefit from ongoing economic, social and technological change to deliver outperformance over the medium and long term.

5.4 Royal London returns have underperformed against the benchmark in the last 12 months, 3 and 5 years annualised, but are well ahead over the ten year period. The difference in performance between the fund and the benchmark is as a result of lower than average income and capital returns, with returns from office, retail and industrial sectors being below the benchmark. This has been partly offset by the fund keeping voids low at 4.4% compared to a benchmark figure of 7.6%.

5.5 The aim of the fund 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.

5.6 Blackrock is very slightly behind the benchmark performance over all periods. Currently the fund is deliberately limiting the transactional activity in the fund after completing repositioning the fund a number of years ago. The fund is strategically positioned, underweight in High Street Retail and Central London Offices and overweight in Industrial and Other Properties. The Fund's core investment strategies are in primary healthcare, student accommodation, multi-let industrials and logistics warehouse development. During 2017/18 this has continued with the fund increasing the allocation to industrials. 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.

5.7 Aberdeen Standard is behind the benchmark over all periods. The key factors in the underperformance were shopping centre holdings (due to low demand and negative news from prominent retailers) and indirect retail holdings which have delivered flat capital values. The industrial portfolio continues to perform well, with rental value growth and modest capital growth, even in light of recent company voluntary arrangements (CVA's). London and provincial offices have also seen incremental improvement in performance. The Aberdeen Standard 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.

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 activity are set out below.

RREEF Ventures III Unit Trust

6.2 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 31 March 2018 was £0.5m. 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. The final property was due to be disposed of in March 2018, however, papers were pulled on the original buyer and simultaneously put under offer by the second bidder. The sale is now planned to complete after Q2 2018.

6.3 Total distributions since inception to 31 March 2018 are £3.1m. The year end investment multiple (the value plus the distributions received, divided by the total capital committed) is 0.36.

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

6.4 The Committee approved the investment in October 2005 of €15m (£13.2m). 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, 67.2% of the aggregated invested capital has been returned by the underlying Real Estate Funds.

6.5 At 31 March 2018 the Fund's investment is valued at £1.2m, but the valuation of the underlying funds is as at a terminal valuation, and therefore very prudent. Since inception €8.3m (£6.7m) has been distributed, and the year end investment multiple was 0.59. As at 31 March 2018 since inception the internal rate of return for the fund is -6.7%.

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

6.6 The Committee approved the investment in October 2007 of $25m (£17.8m), with $4m (£2.8m) left to be drawn down as at 31 March 2018. The Fund made a total of sixteen investments, and at this stage six Funds have fully completed the disposition of their assets, another has only one asset remaining and three are close to full realisation.

6.7 The value of the Pension Funds investment is £2.7m at 31 March 2018, but the valuation of the underlying funds is as at a terminal valuation, and therefore very prudent. Since inception $18.7m (£12.3m) has been distributed, and the year end investment multiple was 0.84, 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.

Igloo Regeneration Partnership

6.8 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.

6.9 On 1 July 2017 the partnership entered into an 18 month 'wind up' period with assets being marketed for sale. As at 31 March 2018 the Pension Fund's investment value is £2.5m, having distributed £5.3m since inception, resulting in an investment multiple of 0.8. In mid-June a further £20m was distributed to investors, with the Pension Fund receiving their share £1.4m.

7. EUROPEAN BALANCED PROPERTY FUND

Aberdeen Standard European Property Growth Fund – Unit Trust

7.1 To diversify the Fund's balanced property exposure, a commitment of €5m (£4.4m) was made in November 2002 to a new pooled investment vehicle created by Aberdeen Standard to invest in Continental European property. A further commitment of €10m (£8.8m) was approved to the European Property Growth Fund in July 2005. The Fund owns office, retail and distribution properties in France, Netherlands, Germany, Denmark, Ireland, Spain, Poland and Belgium. Re-positioning of the fund over the past few years is now complete. This restructuring has led to: increased average lot sizes, increased exposure to stable low-volatility markets, improved performance and a structure that generates returns from both capital growth and income, helping to make the portfolio more resilient cross economic cycles.

7.2 As at the 31 March 2018, this commitment had been fully drawn and the investment in the Fund was valued at £12.0m. Distributions of €5.9m (£4.7m) have been received, producing an investment multiple of 1.26.

8. INFRASTRUCTURE

Innisfree Investments

8.1 The Fund has made commitments to funds managed by this 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.

8.2 During the year income from these holdings was reinvested to fund further drawdowns. No redemptions were made.

Innisfree Continuation Fund II – partnership

8.3 The Committee approved a commitment of £8m to the Innisfree Continuation Fund II in January 2006. During 2015/16 the Pension Fund also purchased £0.5m from the investor commitment of BAE Systems Pension Fund.

8.4 Following this Fund's acquisition of assets from an earlier Innisfree primary fund in April 2006, plus a number of subsequent follow on investments and disposals the fund now has a total of £337m committed to 12 project investments, all of which are operational. Fund assets include: three hospitals, five education projects, three accommodation projects all in the UK and a Dutch high speed rail link. From inception, the Fund's portfolio of investments has generated returns that are 32% higher than was anticipated in the base case acquisition model, and investors have received an average net yield of 9.1%, compared to the 7.2% forecast.

8.5 The investment is currently valued at £8.2m and has distributed £5.9m to 31 March 2018 (with a further £0.3m distributed in April 2018 relating to the six month period up to the end of March 2018). The current investment multiple is 1.7.

Innisfree Secondary Fund (ISF) – partnership

8.6 The Committee approved a commitment of £15m to the Innisfree Secondary Fund in July 2007. During 2015/16 the Pension Fund also purchased £1.5m from the investor commitment of BAE Systems Pension Fund.

8.7 Secondary Funds are long term holders of PPP (public/private partnerships) and PFI (private finance initiatives) 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, and now has 16 limited partners. As at 31 March 2018, the Fund had total commitments of £589.6m to 33 projects, and around 98% of investor commitments have been cash drawn. Projects include schools, hospitals, infrastructure and MOD buildings in the UK, Canada and Sweden.

8.8 The investment is currently valued at £16.6m, having distributed £6.0m to 31 March 2018 (with a further £0.6m distributed in April 2018 relating to the six month period up to the end of March 2018). The current investment multiple is 1.4.

Innisfree Secondary Fund 2 (ISF2) – partnership

8.9 The Committee approved a commitment of £10m to the Innisfree Secondary Fund 2 in January 2013. ISF2 had its final closing on 31 March 2013, taking aggregate commitments to £544m, with 11 limited partners. The Fund was 74% committed to investments and 74% of investor commitment had been cash drawn at 31 March 2018. The Fund is similar to ISF and is invested in projects including schools, hospitals and Thameslink, in the UK, Canada and Sweden.

8.10 The investment is currently valued at £7.7m, with outstanding commitments of £1.7m, and having distributed £2.1m to 31 March 2018 (with a further £0.3m distributed in April 2018 relating to the six month period up to the end of March 2018). Although still early on in the investment cycle, the current investment multiple is 1.0, with an internal rate of return of 10.9%.

Other Infrastructure Investments

8.11 The Committee approved an increased commitment to infrastructure in January 2017. This set the strategic allocation to infrastructure at 1.5% of the fund. Following research and due diligence undertaken by Officers and the Investment Consultant it was agreed to commit £15m to Infracapital Greenfield Partners I in

August 2017 and $21m (£15.0m) to Pantheon Global Infrastructure III in February 2018.

8.12 During the year £3.1m was invested into these infrastructure schemes: £1.6m in Infracapital Greenfield Partners I and £1.5m in Pantheon Global Infrastructure III. No redemptions were made.

Infracapital Greenfield Partners I

8.13 The Committee approved an increased commitment to infrastructure in January 2017, with a £15m commitment being made to Infracapital Greenfield Partners I in August 2017. This fund is targeting £1 billion in capital commitments to create a diversified portfolio of European greenfield economic infrastructure investments, in order to provide investors with capital appreciation and yield. It will focus on later stage development, construction and/or expansion of long-term infrastructure through projects and corporates. IGP I will target eight to fifteen investments, based on an equity investment in the range of £25m to £200m, including buy and build investments or roll out strategies. The fund has a 25 year term and is targeting a mid-teens gross IRR over the entire life of the Fund. There are two phases to the fund's life – an initial period where significant capital appreciation is expected, and an operating period during which high teens yield is expected to be delivered. Investors will have the opportunity to exit after the initial period, or (with more than 66.6% investor support) continue to the operating period.

8.14 This fund has currently made commitments of £596.2m to seven schemes. The projects include: broadband infrastructure, bio- and solar energy, new train rolling stock and a portfolio of PPP assets. The pension fund's investment is currently valued at £1.5m, with outstanding commitments of £13.5m. To 31 March 2018 there have been no distributions. This is to be expected as this is a new fund.

Pantheon Global Infrastructure III

8.15 The Committee approved an increased commitment to infrastructure in January 2017, with a $21m (£15.0m) commitment being made to Pantheon Global Infrastructure III in February 2018. This is a fund-of-funds, targeting a capital raising of $1.2bn. The Fund's strategy is focused on a combination of secondaries and co-investments in infrastructure opportunities. The Fund is targeting an equal allocation across midstream energy, power and utilities, transportation, social infrastructure and 'other' (including telecommunications).

8.16 The pension fund's investment is currently valued at £1.5m, with outstanding commitments of $18.9m (£13.5m). To 31 March 2018 there have been no distributions. This is to be expected as this is a new fund.

Conclusion

9.1 Overall, the Pension Fund's investment in property and infrastructure generated a return of 8.11%, which was behind the benchmark (as measured by JP Morgan) return of 8.91%, however, within this there is significant a significant variation in performance.

9.2 The property allocation, at 9.5%, is slightly overweight its benchmark allocation, with 2.2% in undrawn commitments, and Infrastructure, at 1.6%, is underweight its benchmark allocation, however, there is a further £35.9m 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	
Appendix A	UK Balanced Property Allocation – March 2018

Background Papers

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