Lincolnshire COUNTY COUNCIL
Working for a better future

Regulatory and Other Committee

Open Report on behalf of Andrew Crookham, Executive Director – Resources

Report to:	**Pensions Committee**
Date:	**18 July 2019**
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 2019.

Recommendation(s):

The Committee note the report.

Background

1. Introduction

1.1 The Fund's investment exposure to property and infrastructure is achieved via holdings in pooled vehicles.

1.2 The Fund's strategic allocation of 9.0% to property is slightly higher than the average local authority pension fund, currently at 7.8%. The market value of holdings in property pooled vehicles at 31 March 2019 was £202.9m (8.6% 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.

1.3 The Fund also has a 2.5% strategic allocation to infrastructure and has made commitments to Private Finance Infrastructure schemes. Again this is slightly higher than the average local authority pension fund, which is currently 1.1%. The market value of holdings in infrastructure pooled vehicles at 31 March 2019 was £44.4m (1.9% of the Fund).

1.4 The table over sets out the Fund's holdings as at 31 March 2019.

Market value of property and other holdings at 31 March 2019

Property Pooled Investment Vehicle	Undrawn Commitments 31/03/2019 £m	Market value of LCC holdings 31/03/2019 £m
BALANCED UK PROPERTY		
Aviva Pooled Property Fund	n/a	48.5
Royal London Exempt Unit Trust	n/a	24.2
Blackrock – UK Property Unit Trust	n/a	42.1
Aberdeen Standard - Trustee Investment Plan	n/a	63.8
Total Balanced UK Property	**n/a**	**178.6**
PROPERTY VENTURES		
RREEF – Property Ventures Fund III	0.0	0.5
Franklin Templeton European Fund of Funds	0.3	0.8
Franklin Templeton Asian Fund of Funds	3.0	1.9
Igloo Regeneration partnership	0.0	1.0
Total Property Ventures	**3.3**	**4.2**
EUROPEAN COMMERCIAL PROPERTY		
Aberdeen Standard European Growth Fund	**0.0**	**12.1**
INFRASTRUCTURE		
Innisfree PFI Continuation Fund II	0.5	8.2
Innisfree PFI Secondary Fund	1.4	16.8
Innisfree PFI Secondary Fund 2	1.7	7.7
Infracapital Greenfield Partners I	8.8	7.7
Pantheon Global Infrastructure III	12.4	4.0
Total Infrastructure	**24.8**	**44.4**
Property/Infrastructure Cash	**n/a**	**8.0**
TOTAL PROPERTY AND INFRASTRUCTURE	**28.1**	**247.3**

1.5 The performance of the property and infrastructure holdings during 2018/19 was as follows:

- UK Commercial Property Unit Trusts return in the year saw an under performance, of 1.74% against a benchmark of 4.88%;
- Property Ventures was a significant out performance of 11.07% against the benchmark of 7.00%; and
- Infrastructure also saw a significant out performance of 12.21% against a benchmark of 6.00%.

The overall return on the portfolio was 4.25% compared to a benchmark performance of 5.31%. UK Commercial Property Units represents 72% of the property and infrastructure holdings. Their underperformance was not out weighed by the outperformance seen for Property Venture and Infrastructure

1.6 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 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.

2.2 During the year income from the holdings was reinvested. No redemptions were made.

2.3 **Appendix A** illustrates the overall UK property sector and regional weightings of the individual pooled vehicles.

Overall UK property sector asset weightings at 31 March 2019

Property Sector	LCC Fund %	IPD %	Difference %
Retail	27.0	27.0	0.0
Offices	31.2	29.1	2.1
Industrial	29.6	29.2	0.4
Other	12.3	14.7	-2.4
Total	**100.0**	**100.0**	

2.4 Overall, the Fund's property allocation, when compared to an index of similar property funds, is overweight Shopping Centres, Offices in London and Industrials in the South East. The Fund is underweight Standard and Warehouse Retail, Offices in the South East and the rest of the UK, the Industrial sector in the rest of the UK, "Other" properties (which includes properties such as leisure, residential and listed assets) and cash.

2.5 At an individual fund level:

- Aviva has no allocation to shopping centres and is also underweight in industrials in the rest of the UK. They are significantly overweight in London offices.

- Royal London has an overweight position in offices in London and underweight in industrials in the rest of the UK. They have no allocation to shopping centres. Property sizes are generally smaller when compared to the other managers.

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

- Aberdeen Standard is overweight shopping centres and industrials in the south east. They are underweight other property and offices in the south east.

3. Market Environment in the Period Reported

3.1 Property produced total returns of 4.88% (IPD index), over the twelve months to 31 March 2019, compared to UK equity returns of 6.36% (FTSE All Share) and UK index-linked bond returns of 2.20%.

3.2 The following paragraphs set out the UK property market environment for the year 2018/19:

- Q2 2018 UK commercial real estate delivered modest capital growth during the quarter, but at the sector level, there was further divergence in performance. While industrials continued to outperform the wider UK real estate market, signs of a slowdown in offices were more apparent and there was further distress on the high street. Mothercare and House of Fraser were the latest retailers to resort to CVAs (company voluntary arrangements), while others like M&S looked to rationalise their physical store portfolios. In this environment, real estate investors remained focused on assets in good locations, offering resilient income.

- Q3 2018 UK commercial property remained stable, although there were some indications during the quarter that the market was moderating. Total returns had been marginally weaker in recent months, with the return for August (the latest data available) the lowest since September 2016. Although capital growth was weaker, rents held up fairly well – particularly for industrial and office property. Market trends continued to see industrial and retail property move in opposite directions. Industrials were still outperforming all the other commercial sectors as the relentless demand for all types of storage and distribution facilities drove the sector higher.

- Q4 2018 Total returns continued to slow amid a difficult period for the UK commercial property market. As expected, 2018 was a weaker year for real estate. Full-year returns were unlikely to match the double figures achieved in 2017. Ongoing uncertainty surrounding the Brexit withdrawal agreement caused investors to be more cautious. Over the last nine years, real estate had delivered returns of more than 10% per year. However, the market was at a late stage in the cycle and valuations appeared expensive relative to their long-term worth, therefore returns were expected to be lower going forwards.

- Q1 2019 It was a weak start to the year for UK commercial real estate. Monthly total returns continued to slow and were barely positive. As property values were reassessed, capital growth turned negative at an all-property level. This was largely a result of weakening values for large-scale retail assets (e.g. retail warehouses and shopping centres). Industrials in the South East remained the strongest sector and capital values continued to rise for these assets. Central London offices continued to slow having defied the odds in the face of heightened levels of Brexit uncertainty.

4. Outlook

4.1 Returns are expected to remain subdued in the period ahead with a difficult economic backdrop likely to bring rental decline to many parts of the market. Given its many challenges, the retail sector looks especially vulnerable to significant rental decline. Central London office rents are also likely to correct in the face of significant new supply and Brexit-related uncertainty. Regional centres appear considerably more defensive. Industrial occupier markets are structurally well placed, however, current rates of rental growth in the sector appear unsustainable. In turn, weaker occupier markets are likely to induce greater caution on the part of investors though; with yield-driven buyers propping up the market in recent times, the latest shift in stance from the major central banks may help to sustain this demand for a while yet.

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 31 March 2019

	2018 / 2019 %	**3 years Annualised %**	**5 years Annualised %**	**10 years Annualised %**
Aviva	3.4	5.1	7.9	7.2
Royal London	2.5	4.5	7.1	7.7
Blackrock	4.9	6.1	8.5	8.0
Aberdeen Standard	-0.2	3.3	7.1	7.3
IPD UK PPFI All Balanced Median return	4.8	6.2	9.1	8.3

5.2 Aviva has underperformed the one year benchmark, delivering 3.4%, which was below the benchmark of 4.8%. The Fund's three year relative performance has steadily improved since September 2016, and in Q1 2019 relative performance was -1.0% compared to -2.1% 24 months ago. This performance improvement is expected to continue as the strategic sale assets are completed and sustainable income growth is driven from a core portfolio of high quality assets in strategic locations.

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 all periods. The difference in performance between the fund and the benchmark is as a result of lower than average capital returns, the fund's income return is ahead of benchmark. Returns from industrial and other commercial sector were ahead of the benchmark, while office and retails returns were below.

5.5 The aim of the fund is to maximise returns from an appropriately diversified portfolio consisting of Retail, Industrial and Office properties. The strategy is to acquire properties of suitable quality for the fund at times in market cycles when relative values are low, and to manage the properties actively and effectively until selected sales can be made to take advantage of buoyant conditions. It is intended that in most cases properties acquired for the fund will be fully let and income producing to tenants of sound financial strength.

5.6 Blackrock is ahead of the one year benchmark, and only very slightly behind the benchmark performance in all other periods. The fund is strategically positioned 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 2018/19 vacancy levels fell to 5.6%, against a benchmark of 7.1%. The fund secured a number of significant leasing agreements on the 'build to hold' logistics part of portfolio, they purchased a 178 bed hotel and have commenced development of a four unit industrial scheme.

5.7 Aberdeen Standard is behind the benchmark over all periods, particularly in the last 12 months. The key factors in the underperformance were retail holdings. To tackle this the fund has decided to place two shopping centre assets under offer, although this has contributed significantly to the underperformance these proposed sales will improve the funds overall structure. Further restructuring of the fund, including, the sale of three leasehold office assets, the acquisition of central London student accommodation property, and two industrial should strengthen future prospects for the fund.

5.8 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. 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. 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 value of the Fund's units at 31 March 2019 was £0.5m. The Fund continues to be wound up, with just the final property to be disposed.

6.3 Total distributions since inception to 31 March 2019 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, 69.8% of the aggregated invested capital has been returned by the underlying Real Estate Funds.

6.5 At 31 March 2019 the Fund's investment is valued at £0.8m, but the valuation of the underlying funds is as at a terminal valuation, and therefore very prudent. Since inception €8.7m (£7.0m) has been distributed, and the year end investment multiple was 0.66. As at 31 March 2019 since inception the internal rate of return for the fund is -7.3%. Although the success of the individual investments within the fund has varied, performance overall has been substantially below target.

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 (£3.0m) left to be drawn down as at 31 March 2019. The Fund has made a total of sixteen investments, and at this stage six Funds have fully completed the disposition of their assets, another two only have one asset remaining.

6.7 The value of the Pension Funds investment is £1.9m at 31 March 2019, but the valuation of the underlying funds is as at a terminal valuation, and therefore very prudent. Since inception $20.2m (£13.4m) has been distributed, and the year end investment multiple was 1.30, with an internal rate of return of 0.71%. 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 a 'wind up' period with assets being marketed for sale, since this date the fund has made two distributions to investors. As at 31 March 2019 the Pension Fund's investment value is £1.0m, having distributed £6.7m since inception, resulting in an investment multiple of 0.77.

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 in July 2005. The Fund mainly owns office, retail and distribution properties in the Eurozone, and to a limited degree in other European countries. The fund continues to be focused on ensuring that the portfolio is well balanced between core markets, with a tactical exposure to recovery markets.

7.2 As at the 31 March 2019, this commitment had been fully drawn and the investment in the Fund was valued at £12.1m. Distributions of €6.0m (£4.8m) have been received.

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 £340m 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 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 £6.6m to 31 March 2019 (with a further £0.3m distributed in April 2019 relating to the six month period up to the end of March 2019). At 31 March 2019 the forecast long term gross IRR of the portfolio was 11.3%, compared to 8.75% in the acquisition base case.

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 15 limited partners. As at 31 March 2019, the Fund had total commitments of £590.0m 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 £16.8m, having distributed £7.2m to 31 March 2019 (with a further £0.6m distributed in April 2018 relating to the six month period up to the end of March 2018).

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 12 limited partners. The Fund was 74% committed to investments and 74% of investor commitment had been cash drawn at 31 March 2019. 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 £2.6m to 31 March 2019 (with a further £0.4m distributed in April 2019 relating to the six month period up to the end of March 2018). At 31 March 2019 the forecast long term gross IRR of the portfolio was 11.0%.

Other Infrastructure Investments

8.11 The Committee approved an increased commitment to infrastructure in January 2017. This set the strategic allocation to infrastructure at 2.5% 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 £8.4m was invested into these infrastructure schemes: £4.8m in Infracapital Greenfield Partners I and £3.6m in Pantheon Global Infrastructure III. No redemptions were made. It is too early to report on performance for these funds.

Infracapital Greenfield Partners I

8.13 The Committee approved 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 £826.12m to eight 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 £7.7m, with outstanding commitments of £8.8m. To 31 March

2019 there has been a small distribution of £76k, this is to be expected as this is a new fund. It is too early to report on performance for this 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 £4.0m, with outstanding commitments of $16.2m (£12.5m). To 31 March 2019 there has been a small distribution of £25k, this is to be expected as this is a new fund. It is too early to report on performance for this fund.

Conclusion

9.1 Overall, the Pension Fund's investment in property and infrastructure generated a return of 4.25%, which was behind the benchmark (as measured by JP Morgan) return of 5.31%, however, within this there is significant a significant variation in performance.

9.2 The property allocation, at 8.6%, is slightly underweight its benchmark allocation, with 1.7% in undrawn commitments, and infrastructure, at 1.9%, is also underweight its benchmark allocation, however, there is a further £24.8m 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 2019

This report was written by Claire Machej, who can be contacted on 01522 553641 or claire.machej@lincolnshire.gov.uk.

This page is intentionally left blank