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:	**16 July 2020**
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 2020.

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 8.1%. The market value of holdings in property pooled vehicles at 31 March 2020 was £200.0m (9.0% 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. Again this is slightly higher than the average local authority pension fund, which is currently 1.26%. The market value of holdings in infrastructure pooled vehicles at 31 March 2020 was £49.6m (2.2% of the Fund).

1.4 The Fund's total property and infrastructure holdings as at 31 March 2020 are set out in table one over the page.

Table One: Market value of property and infrastructure holdings at 31 March 2020

Property Pooled Investment Vehicle	**Market value of holdings at 31 March 2019 £m**	**Market value of holdings at 31 March 2020 £m**
Balanced UK Property	178.6	175.5
Property Ventures	4.2	2.2
European Commercial Property	12.1	13.2
Infrastructure	44.4	47.8
Property/Infrastructure Cash	8.0	10.9
TOTAL PROPERTY AND INFRASTRUCTURE	**247.3**	**249.6**

1.5 The performance of the property and infrastructure holdings during 2019/20 was as follows:

- UK Commercial Property Unit Trusts return in the year saw an under performance, of -0.27% against a benchmark of -0.01%;
- Property Ventures was a significant underperformance of -4.81% against the benchmark of 7.00%; and
- Infrastructure also saw an underperformance of 4.98% against a benchmark of 6.00%.

1.6 To give this some context against other elements of the market, property holdings produced indexed returns of -0.01% (IPD index), over the twelve months to 31 March 2020, compared to UK equity returns of -18.45% (FTSE All Share) and UK index-linked bond returns of 0.22%.

1.7 The end of 2019/20 saw all markets significantly impacted by the coronavirus pandemic. The financial year ended with the imposition of a UK-wide lockdown following the onset of the Covid-19 pandemic, and significant disruption to the economy and real estate markets. As a result of this there is significant amount of uncertainty around the valuation of property funds and assets at 31 March 2020. This 'material valuation uncertainty' has been reflected in the valuations we have received for the four UK Commercial Property Funds and the European Property Growth Fund. This is likely to remain in place until the emergence of greater market transparency and transactional evidence, which may be forthcoming at different times for different sectors of the property market. Dealing in these Funds was also suspended from mid-March as an accurate market value for an orderly sale cannot be made at this time. These funds will remain suspended until this can be done.

1.8 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 UK Commercial Property holdings represent the majority of the fund's property and infrastructure holdings (70.3% of holdings as at 31 March 2020). 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. A breakdown of holdings is set out in Table Two below. Offices are in regular contact with the various managers to monitor performance.

Table Two: Balanced UK Commercial Property holdings as at 31 March 2020

	Market value of holdings at 31 March 2020 £m
Aviva Pooled Property Fund	48.2
Royal London Exempt Unit Trust	24.2
Blackrock – UK Property Unit Trust	40.1
Aberdeen Standard - Trustee Investment Plan	63.0
Total Balanced UK Property	**175.5**

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

2.3 Table three below summaries the overall UK property sector in the Lincolnshire Portfolio verses the market index. **Appendix A** provides further details of the overall UK property sector and regional weightings of the individual pooled vehicles verses the index.

Table Three: Overall UK property sector asset weightings at 31 March 2020

Property Sector	**Lincolnshire Fund %**	**IPD %**	**Difference %**
Retail	21.7	23.0	-1.3
Offices	26.3	29.7	-3.4
Industrial	33.3	30.7	2.6
Other	18.7	16.6	1.9
Total	**100.0**	**100.0**	

2.4 Overall, the Fund's property allocation, when compared to an index of similar property funds, is overweight Offices in London, Industrials in the South East and cash. The Fund is underweight Offices in the South East and the rest of the UK, and Standard Retail.

2.5 At an individual fund level:

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

- Royal London has no allocation to shopping centres or offices in the rest of the UK. They have an overweight position in offices in London and underweight in offices in the south east. 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.

Investment Performance

2.6 Table four 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 specifically to Lincolnshire Pension Fund.

Table Four: UK Commercial Property Investment returns to 31 March 2020

	2019 / 2020 %	3 years Annualised %	5 years Annualised %	10 years Annualised %
Aviva	-0.5	5.0	4.8	6.0
Royal London	0.1	3.4	4.5	6.4
Blackrock	-1.2	4.4	5.3	6.7
Aberdeen Standard	-1.5	2.3	3.5	6.0
IPD UK PPFI All Balanced Median return	0.0	4.8	5.8	7.1

2.7 Aviva has underperformed the one year benchmark, delivering -0.5%, which was below the benchmark of 0.0%. The Fund's relative performance has steadily improved since September 2016 from a programme of strategic sales and repositioning. The Funds concentration of high-quality office and industrial assets in London and underweight exposure to the retail sector should help with its resilience. By the end of Q1 2020 the Fund's void rate reduced to 6.5%, against a benchmark of 8.9%.

2.8 This fund focuses on: Income Growth – delivering income growth through rent reviews, lease renewals, new lettings, repositioning assets and the creation of additional or higher value space; Portfolio Resilience – a concentrated high-quality portfolio with low credit risk and diverse income characteristics and Focused Strategy – investing in target locations that will benefit from economic, social and technological change to deliver outperformance over the long term.

2.9 Royal London returns have underperformed against the benchmark in all periods except the last 12 month, although performance here has only above the benchmark (0.1% against a benchmark of 0.0%). The Fund has seen higher income return and experienced lower capital declines compared to the benchmark during the last year. Industrials and offices have shown most resilience whilst retail and alternatives lagged behind. The Fund has benefited from having no shopping centres in the portfolio.

2.10 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 generating income from tenants of sound financial strength.

2.11 Blackrock is behind the benchmark in all periods, including -1.2% against a benchmark of 0.0% for the last 12 months. Much of the underperformance in the last 12 months relates to a capital reduction in values at 31 March 2020. The Fund's core investment strategies are in other property (including: primary healthcare and student accommodation), multi-let industrials and logistics warehouse development. The Fund believes it is well positioned with lower vacancy rates, lower concentration of top ten tenants and less leases expiring in the next five years than the benchmark.

2.12 Aberdeen Standard is significantly behind the benchmark over all periods, particularly in the last 12 months. Much of the underperformance in the last 12 months relates to a capital reduction in values at 31 March 2020 and the Funds overweight position in shopping centres. The Fund is continuing to reduce its retail exposure, in particular its shopping centre holdings, though sales and redevelopments.

2.13 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.

Outlook

2.14 2020 is likely to be a very challenging year. The full extent of the impact of Covid-19 on UK real estate markets and the relative performance of the various real estate sectors is still to be seen. Although it is expected it will lead to an acceleration in the decline of retail rental values. Occupiers are facing entirely new conditions and many businesses will be forced to close. Many other companies are likely to face cashflow issues, which will impact on their ability to pay rent. It is believed that retail and leisure will be worst affected areas, with supermarkets, industrial assets and primary health care proving more resilient.

3. PROPERTY VENTURES

3.1 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. Table five, below, set out details of the four Funds held. These 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.

Table Five: Property Venture holdings as at 31 March 2020

	Undrawn Commitments 31 March 2020 £m	**Market value of holdings at 31 March 2020 £m**
RREEF – Property Ventures Fund III	0.0	0.5
Franklin Templeton European Fund of Funds	0.3	0.3
Franklin Templeton Asian Fund of Funds	3.0	1.1
Igloo Regeneration partnership	0.0	0.3
Total Property Ventures	**3.3**	**2.2**

RREEF Ventures III Unit Trust

3.2 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 2020 was £0.5m. The Fund has disposed of all properties and is now in the final stages of wind-down. This involves the termination of all the fund structures and return of capital to investors. A distribution was paid in May 2020 and a final distribution is likely during the second half of 2020/21.

3.3 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

3.4 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, 70.3% of the aggregated invested capital has been returned by the underlying real estate funds.

3.5 At 31 March 2020 the Fund's investment is valued at £0.3m, 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 0.62. As at 31 March 2020 since inception the internal rate of return for the fund is -7.56%. 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

3.6 The Committee approved the investment in October 2007 of $25m (£21.1m), with $3.7m (£3.0m) left to be drawn down as at 31 March 2020. The Fund has made a total of sixteen investments and by the end of March 2020 there is only one underlying investment fund with unrealised assets remaining in the fund.

3.7 The value of the Pension Funds investment is £1.1m at 31 March 2020, but the valuation of the underlying funds is as at a terminal valuation, and therefore very prudent. Since inception $20.9m (£14.0m) has been distributed, and the year end investment multiple was 1.25, with an internal rate of return of 0.53%. Managers are pleased with the portfolio assembled and the progress that has been achieved to date.

Igloo Regeneration Partnership

3.8 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.

3.9 On 1 July 2017 the partnership entered into a 'wind up' period with assets being marketed for sale. By 31 March 2020 all assets had been sold and the fund hopes to make the last payment to investors by the end of the calendar year. As at 31 March 2020 the Pension Fund's investment value is £0.3m, having distributed £7.5m since inception, resulting in an investment multiple of 0.78.

4. EUROPEAN BALANCED PROPERTY FUND

Aberdeen Standard European Property Growth Fund – Unit Trust

4.1 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 offices 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.

4.2 As at the 31 March 2020, this commitment had been fully drawn and the investment in the Fund was valued at £13.2m. Distributions of €6.5m (£5.2m) have been received.

5. INFRASTRUCTURE

5.1 In addition to the property allocations the Fund has made a 2.5% strategic allocation to infrastructure. This is made up commitments to three private finance initiate (PFI) funds with Innisfree, plus a further two new investments with Infracapital and Pantheon (see Table Six below).

Table Six: Infrastructure holdings as at 31 March 2020

	Undrawn Commitments 31 March 2020 £m	Market value of holdings at 31 March 2020 £m
Innisfree PFI Continuation Fund II	0.5	8.3
Innisfree PFI Secondary Fund	1.4	16.8
Innisfree PFI Secondary Fund 2	1.2	8.7
Infracapital Greenfield Partners I	7.3	9.5
Pantheon Global Infrastructure III	14.9	4.5
Total Infrastructure	**25.3**	**47.8**

Innisfree Investments

5.2 The Fund has made commitments to funds managed by this specialist investor in PFI 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.

Innisfree Continuation Fund II – partnership

5.3 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.

5.4 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 higher than was anticipated in the base case acquisition model, and investors have received an average net yield of 9.0%, compared to the 7.2% forecast.

5.5 The investment is currently valued at £8.3m and has distributed £7.4m to 31 March 2020 (with a further £0.3m distributed in April 2020 relating to the six month period up to the end of March 2020). At 31 March 2020 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

5.6 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.

5.7 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, 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, MOD buildings and infrastructure (roads – M6), in the UK, Canada and Sweden.

5.8 The investment is currently valued at £16.8m, having distributed £9.0m to 31 March 2020 (with a further £0.6m distributed in April 2020 relating to the six month period up to the end of March 2020).

Innisfree Secondary Fund 2 (ISF2) – partnership

5.9 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 79.7% committed to investments and 79.7% of investor commitment had been cash drawn at 31 March 2020. The Fund is similar to ISF and is invested in projects including schools, hospitals, MOD buildings and infrastructure (Thameslink), in the UK, Canada and Sweden.

5.10 The investment is currently valued at £8.7m, with outstanding commitments of £1.2m, and having distributed £3.7m to 31 March 2020 (with a further £0.4m distributed in April 2020 relating to the six month period up to the end of March 2020). At 31 March 2020 the forecast long term gross IRR of the portfolio was 10.6%.

Other Infrastructure Investments

5.11 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 (£16.9m) to Pantheon Global Infrastructure III in February 2018.

5.12 During the year £2.0m was invested into these infrastructure schemes: £1.5m in Infracapital Greenfield Partners I and £0.5m in Pantheon Global Infrastructure III. No redemptions were made. It is too early to report on performance for these funds.

Infracapital Greenfield Partners I

5.13 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.

5.14 This fund has currently made commitments of £932.7m to nine schemes. The projects include: broadband infrastructure, bio, solar and wind energy, new train rolling stock and a portfolio of PPP assets. The pension fund's investment is currently valued at £9.5m, with outstanding commitments of £7.3m. It is too early to report on performance for this fund.

Pantheon Global Infrastructure III

5.15 The Committee approved an increased commitment to infrastructure in January 2017, with a $21m (£16.9m) 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 secondary 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). The fund is currently 40.4% committed.

5.16 The pension fund's investment is currently valued at £4.5m, with outstanding commitments of $14.9m (£12.0m). It is too early to report on performance for this fund.

6. BORDER TO COAST PROPERTY AND INFRASTRUCTURE SUB-FUNDS & FUTURE INVESTMENTS

6.1 The intention is for Border to Coast to build a UK property fund (holding direct real estate) which will replace the Funds current property allocations which are made using UK commercial property funds, and some specialist/regional funds. Work on this sub-fund is underway, but given the complexity of unwinding existing property holdings, the cost of transacting in property and the illiquidity of these assets the timeline for moving into this fund is long. Current estimates are that the Border to Coast UK property sub-fund will not be operational until 2022.

6.2 In the meantime the Fund has available cash to commit to property schemes. It was agreed at the October 2018 Committee meeting to increase the allocation property by 1.5%, but to diversify from UK commercial property. Discussion was had at the December 2019 meeting about an investment opportunity in residential property, where there is currently a lot of interest from institutional investors, particularly in the private rental sector. A recommendation relating to this type of investment will be considered by the Committee at item 13 on this agenda.

6.3 The Fund currently has a separate allocation to infrastructure, plus some additional infrastructure investments within the diversified alternatives mandate managed by Morgan Stanley. Future infrastructure investments will be made through the Border to Coast once their full range of diversified alternatives funds is up and running. This is not likely to be before April 2021.

7. Conclusion

7.1 Overall, the Pension Fund's investment in property generated a return of -0.82%, which was behind the benchmark (as measured by Northern Trust) return of 0.75%, however, within this there is significant a significant variation in performance. Infrastructure generated a return of 4.98%, which was behind the benchmark of 6.0%.

7.2 The property allocation, at 8.1% is slightly underweight its benchmark allocation of 9.0%, however, a further commitment to a new property investment is proposed, and infrastructure, at 2.2%, is also underweight its benchmark allocation, however, there is a further £25.3m 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	
Appendix A	UK Balanced Property Allocation – March 2020

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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