Lincolnshire COUNTY COUNCIL
Working for a better future

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

Report to:	**Pensions Committee**
Date:	**15 July 2021**
Subject:	**Annual Report on the Fund's Property and Infrastructure Investments**

Summary:

This report outlines the performances of the Fund's property and infrastructure investments for the year ended 31 March 2021.

Recommendation(s):

That the Committee note the report.

Background

1.0 Introduction

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

1.2 The Fund's long term strategic allocation of 10.5% to property is slightly higher than the average local authority pension fund, currently at 8.6%. The market value of holdings in property pooled vehicles at 31 March 2021 was £203.9m (7.5% of the Fund). Whilst the majority of exposure is to UK commercial property, to diversify the property allocation the Fund made commitments to a European commercial property, property venture funds and to two private residential housing funds.

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 1.7%. The market value of holdings in infrastructure pooled vehicles at 31 March 2021 was £51.5m (1.9% of the Fund).

1.4 The Fund's total property and infrastructure holdings as at 31 March 2021 are set out in table one over the page.

Table One: Market value of property and infrastructure holdings at 31 March 2021

Property Pooled Investment Vehicle	Market value of holdings at 31 March 2020 £m	Market value of holdings at 31 March 2021 £m
Balanced UK Property	175.5	179.6
Property Ventures	2.2	7.0
European Commercial Property	13.2	13.1
Infrastructure	47.8	49.8
Property/Infrastructure Cash	10.9	5.9
TOTAL PROPERTY AND INFRASTRUCTURE	**249.6**	**255.4**

1.5 The performance of the property and infrastructure holdings during 2020/21 was as follows:

- UK Commercial Property Unit Trusts return in the year saw an out performance of 3.06% against a benchmark of 2.46%;

- Other Property (including the European Property Fund, Property Venture and Private Residential Sector) saw a significant underperformance of -3.52% against the benchmark of 7.00%; and

- Infrastructure also saw an underperformance of 2.09% 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 2.5% (IPD UK All Balanced Fund Index), over the twelve months to 31 March 2021, compared to UK equity returns of 26.7% (FTSE All Share) and UK index-linked bond returns of 2.3%.

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

2.0 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 2021). 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 over the page. Officers are in regular contact with the various managers to monitor performance.

Table Two: Balanced UK Commercial Property holdings as at 31 March 2021

	Market value of holdings at 31 March 2021 £m
Aberdeen Standard – Trustee Investment Plan	65.3
Aviva Pooled Property Fund	49.9
Blackrock – UK Property Unit Trust	40.4
Royal London Exempt Unit Trust	24.0
Total Balanced UK Property	**179.6**

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 2021

Property Sector	Lincolnshire Fund %	IPD %	Difference %
Retail	17.8	19.3	-1.5
Offices	24.7	27.9	-3.2
Industrial	37.9	34.5	3.4
Other	19.6	18.3	1.3
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 and Industrials. 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:

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

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

- Blackrock is overweight other properties (which includes primary care and student accommodation). They are underweight in standard retail and offices in the south east.

- 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 cash and underweight in offices in the south east. Property sizes are generally smaller when compared to the other managers.

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 ten year annualised figure for Blackrock relates to the pooled fund and are not specifically to Lincolnshire Pension Fund.

Table Four: UK Commercial Property Investment returns to 31 March 2021

	2020/21 %	3 years Annualised %	5 years Annualised %	10 years Annualised %
Aberdeen Standard	3.5	0.6	2.4	5.3
Aviva	3.5	2.1	3.6	5.6
Blackrock	4.0	2.5	4.2	6.2
Royal London	-1.3	0.4	2.4	5.3
IPD UK PPFI All Balanced Median return	2.5	2.4	4.1	6.4

2.7 Aberdeen Standard was ahead of the benchmark in the last 12 months, but behind in all other periods. The positive return has come from both capital growth and income returns. The portfolio benefited from being underweight retail versus the benchmark and overweight higher-quality industrial assets. The Fund is continuing to reduce its retail exposure, in particular its shopping centre holdings, though sales and redevelopments.

2.8 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. Typically the fund will invest in a mix of freehold and leasehold properties selected from across the retail, office and industrial sectors.

2.9 Aviva has outperformed the one year benchmark, delivering 3.5%, which was above the benchmark of 2.5%. 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 and leisure sectors have helped

performance over the last 12 months, as have void rates well below the benchmark.

2.10 At the beginning of 2021 a strategic review was undertaken to ensure investors' long-term interests could continue to be served by the Aviva Fund. This review, combined with forecast redemption levels, concluded that the Funds' ability to fully benefit from the economies of scale and the diversification of investments that collective investment schemes normally bring would soon be limited. Size is particularly important for funds that invest in property directly because the costs involved in acquiring, managing and disposing of properties are usually much higher than the costs associated with other asset types. With the reducing economies of scale, it was concluded that it would be in investors' interests to wind-up the Fund. Fund officers are working closely with the manager to ensure the best outcome for the Fund's investment in this property fund.

2.11 Blackrock was ahead of the benchmark in all periods except 10 years. This includes 4.0% against a benchmark of 2.5% for the last 12 months. This outperformance reflects the prime nature of the portfolio and the robust credit strength of the tenant base (a combination of strong existing income and new leasing), combined with the overweight allocation to industrial and healthcare sectors and the underweighting to office and retail.

2.12 The Fund believes it is well positioned for the move out of the pandemic, with its core investment strategies in other property (including: primary healthcare and student accommodation), multi-let industrials and logistics warehouse developments. The Fund is also well positioned from a risk metrics point of view, with lower vacancies, a lower concentration to top 10 tenants and a lower concentration to top 5 assets than the benchmark.

2.13 Royal London returns have underperformed against the benchmark in all periods. The Fund is in the fourth quartile over all time periods. The fund underperformed across all sectors except for the alternatives sector which was driven by a combination of higher income returns and stable capital returns. The most significant underperformance came from retail and office sectors. Both sectors have shown strong income returns, but these have been offset by weaker rental growth.

2.14 The Fund continues to focus on maintaining income levels and managing costs. 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.

Outlook

2.15 It is likely that 2021 will be another challenging year for UK commercial property. Two factors will weigh on long-term prospects; Brexit and the long term effects from the pandemic. It is likely that the pandemic will lead to acceleration in changes to the UK commercial property market. Distribution warehouses and quality multi-let industrial estates are likely to remain highly sought after, while retail and office space will see a decline.

3.0 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, sets out details of the Funds held. These funds have limited lives of between seven and ten years (before extensions).

Table Five: Property Venture holdings as at 31 March 2021

	Undrawn Commitments 31 March 2021 £m	Market value of holdings at 31 March 2021 £m
RREEF – Property Ventures Fund III	0.0	0.1
Igloo Regeneration partnership	0.0	0.3
Franklin Templeton European Fund of Funds	0.3	0.1
Franklin Templeton Asian Fund of Funds	2.7	0.6
Hearthstone Residential Property Fund II	31.8	6.0
Total Property Ventures	**34.8**	**7.0**

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 2021 was £0.07m. 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 July 2021.

3.3 Total distributions since inception to 31 March 2021 are £3.6m. The year end investment multiple (the value plus the distributions received, divided by the total capital committed) is 0.36.

Igloo Regeneration Partnership

3.4 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 focused on the regeneration and repositioning of ten key locations across the UK, delivering developments with market leading levels of high quality, sustainable design.

3.5 On 1 July 2017 the partnership entered into a 'wind up' period with assets being marketed for sale. By 31 March 2021 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 2021 the Pension Fund's investment value is £0.3m, having distributed £7.5m since inception, resulting in an investment multiple of 0.78.

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

3.6 The Committee approved the investment in October 2005 of €15m (£13.2m). The Fund of Funds made commitments to eleven underlying funds, including a portfolio of German nursing homes, a specialist French property investor, a UK real estate partnership, a pan European real estate fund and a German commercial property investor. During the year, the Fund continued the disposition of its investments. On a cumulative basis, 70.5% of the aggregated invested capital has been returned by the underlying real estate funds.

3.7 At 31 March 2021 the Fund's investment is valued at £0.1m, but the valuation of the underlying funds is as at a terminal valuation, and therefore very prudent. Since inception €8.8m (£7.0m) has been distributed, and the year end investment multiple was 0.61. As at 31 March 2021 since inception the internal rate of return (IRR) for the fund is -8.06%. 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

3.8 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 2021. The Fund has made a total of sixteen investments and by the end of March 2021 there is only one underlying investment fund with unrealised assets remaining in the fund.

3.9 The value of the Funds investment is £0.6m at 31 March 2021, but the valuation of the underlying funds is as at a terminal valuation, and therefore very prudent. Since inception $21.0m (£14.1m) has been distributed, and the year end investment multiple was 1.22, with an internal rate of return (IRR) of 0.19%. Although the success of the individual investments within the fund has varied,

overall the manager has been pleased with the portfolio assembled and the progress achieved to date.

Hearthstone Residential Fund 2

3.10 In July 2020 the Committee approved a commitment of £37m to the Hearthstone Residential Fund 2. The Fund aims to establish a portfolio of high quality privately rented houses and low rise apartment blocks, particularly suited to young professionals and families in areas of solid rental demand and good local infrastructure, but where there is a lack of suitable quality rented housing stock. The manager has developed strong relationships with a number of house builders and will build up the portfolio by purchasing units on new developments at an initial discount to the market value.

3.11 During 2020/21 the Fund has drawn down £6.2m. It is too early to report on performance of this Fund.

Allianz Home Equity Fund

3.12 In March 2021 the Committee approved a commitment of £30m to the Allianz Home Equity Fund. The Fund will invest in existing residential properties on a shared ownership basis, whereby an individual will own a minimum of 5% of the property and the fund will own the balance. The individual will pay market rent on the proportion of the property owned by the Fund, and they can gradually increase the proportion of the property they own over time. This is a new concept within the shared ownership model which removes the need for the involvement of a housing association. The pattern of returns is expected to be made up of rental income in the early years followed by capital redemptions in later years.

3.13 No drawdowns have been made by this fund.

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 2021, this commitment had been fully drawn and the investment in the Fund was valued at £13.1m. Distributions of €6.7m (£5.3m) 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 of commitments to three private finance initiative (PFI) funds with Innisfree, plus a further two new investments with Infracapital and Pantheon (see Table six over the page).

Table Six: Infrastructure holdings as at 31 March 2021

	Undrawn Commitments 31 March 2021 £m	Market value of holdings at 31 March 2021 £m
Innisfree PFI Continuation Fund II	0.5	8.3
Innisfree PFI Secondary Fund	1.4	16.8
Innisfree PFI Secondary Fund 2	0.7	8.7
Infracapital Greenfield Partners I	6.4	9.1
Pantheon Global Infrastructure III	8.1	6.9
Total Infrastructure	**17.1**	**49.8**

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 8.9%, compared to the 7.5% forecast.

5.5 The investment is currently valued at £8.3m and has distributed £8.0m to 31 March 2021 (with a further £0.2m distributed in April 2021 relating to the six month period up to the end of March 2021). At 31 March 2021 the forecast long term gross internal rate of return (IRR) of the portfolio was 10.9%, 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 18 limited partners. As at 31 March 2021, 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 £10.5m to 31 March 2021 (with a further £0.7m distributed in April 2021 relating to the six month period up to the end of March 2021). The portfolio of investments is forecast to provide a gross-to-fund long term nominal IRR of 11.2%, a long term nominal net investor IRR of 8.0% and a 10 year nominal average net yield of 8.5% before future optimisation.

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 82.5% committed to investments and 82.5% of investor commitment had been cash drawn at 31 March 2021. 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 £0.7m, and having distributed £4.5m to 31 March 2021 (with a further £0.4m distributed in April 2021 relating to the six month period up to the end of March 2021). The portfolio of investments is forecast to provide a gross-to-fund long term nominal IRR of 10.4%, a long term nominal net investor IRR of 8.7% and a 10 year nominal average yield of 9.0% before future optimisation.

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, £3.6m was invested into these infrastructure schemes: £1.0m in Infracapital Greenfield Partners I and £2.6m in Pantheon Global Infrastructure III. No redemptions were made. It is too early to report on performance for these funds.

Infracapital Greenfield Partners I (IGP 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 £998.m 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 £9.1m, with outstanding commitments of £6.4m. It is too early to report on performance for this fund.

Pantheon Global Infrastructure III

5.15 The Committee approved a $21m (£16.9m) commitment 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 68.4% committed.

5.16 The pension fund's investment is currently valued at £6.9m, with outstanding commitments of $11.2m (£8.1m). It is too early to report on performance for this fund.

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

6.1 The intention is for Border to Coast to build a global and a UK property fund (holding direct real estate and some specialist/regional funds). Work on these sub-funds 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 these funds is long. Current estimates are that the global sub-fund will launch in 2022 and the UK property sub-fund will not be operational until 2023.

6.2 It is anticipated that the current UK commercial property funds will transfer into the Border to Coast UK property sub-fund and current European asset holdings into the global sub-fund. Training on the Fund's strategic asset allocation in September will consider if the Fund want to make a further commitment to the global sub-fund.

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 Border to Coast once their full range of diversified alternatives funds is up and running. This is not likely to be before April 2022.

Conclusion

7.1 Overall, the Pension Fund's investment in property generated a return of 2.32%, which was behind the benchmark (as measured by Northern Trust) return of 2.82%, however, within this there is significant a significant variation in performance. Infrastructure generated a return of 2.09%, which was behind the benchmark of 6.0%.

7.2 The property allocation, at 7.5% is underweight its benchmark allocation of 10.5%, however, the commitments to the two new property investments will address this over the next couple of years. Infrastructure, at 1.9%, is also underweight its benchmark allocation, however, there is a further £17.1m in undrawn commitments.

Consultation

a) Risks and Impact Analysis

The Pension Fund has a risk register which can be obtained by contacting the Head of Pensions.

Appendices

These are listed below and attached at the back of the report	
Appendix A	UK Balanced Property Allocation - March 2021

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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