Lincolnshire COUNTY COUNCIL Working for a better future

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

Report to:	**Pensions Committee**
Date:	**14 July 2022**
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 2022.

Recommendation(s):

The Committee note the report.

Background

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 7.2%. The market value of holdings in property pooled vehicles at 31 March 2022 was £219.4m (7.3% 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 0.6%. The market value of holdings in infrastructure pooled vehicles at 31 March 2022 was £59.2m (2.0% of the Fund).

1.4 The Fund's total property and infrastructure holdings as at 31 March 2022 are set out in table one over the page.

Table One: Market value of property and infrastructure holdings at 31 March 2022

Property Pooled Investment Vehicle	Market value of holdings at 31 March 2021 £m	Market value of holdings at 31 March 2022 £m
Balanced UK Property	179.6	193.8
Property Ventures	7.1	11.5
European Commercial Property	13.1	14.1
Infrastructure	49.8	59.2
Property/Infrastructure Cash	5.9	0.5
TOTAL PROPERTY AND INFRASTRUCTURE	**255.5**	**279.1**

1.5 The performance of the property and infrastructure holdings during 2021/22 was as follows:

- UK Commercial Property Unit Trusts return in the year saw an out performance, returning 26.16% against a benchmark of 23.14%;
- Other Property (including the European Property Fund, Property Venture and Private Residential Sector) saw a significant underperformance, returning 1.54% against the benchmark of 7.00%; and
- Infrastructure saw a significant out performance, returning 12.45% 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 23.14% (IPD UK All Balanced Fund Index), over the twelve months to 31 March 2022, compared to UK equity returns of 13.03% (FTSE All Share) and UK index-linked bond returns of -2.14%.

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 (69.4% of holdings as at 31 March 2022). 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 2022

	Market value of holdings at 31 March 2022 £m
abrdn – Trustee Investment Plan	83.2
Aviva Pooled Property Fund	34.2
Blackrock – UK Property Unit Trust	47.7
Royal London Exempt Unit Trust	28.7
Total Balanced UK Property	**193.8**

2.2 During the year the Pension Fund received £32.2m from the Aviva Pooled Property Fund following the managers decision, on 14 July 2021, to close the fund. For all other funds, income from holdings was reinvested.

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 2022

Property Sector	Lincolnshire Fund %	IPD %	Difference %
Retail	21.1	18.0	3.1
Offices	23.0	24.6	-1.6
Industrial	39.9	42.1	-2.2
Other	16.0	15.3	0.7
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 retail warehouses. The Fund is underweight offices in the south east and the rest of the UK, as well as industrials.

2.5 At an individual fund level:

- abrdn is overweight industrials and underweight retail warehouses and offices in the south east.
- Aviva has no allocation to shopping centres, offices in the rest of the UK and industrials. The portfolio is significantly overweight retail warehouses and offices in the south east. The makeup of their portfolio at 31 March 2022 is significantly influenced by the closure of the Fund and the assets which have been disposed of to date.

- 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 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 not specifically to Lincolnshire Pension Fund.

Table Four: UK Commercial Property Investment returns to 31 March 2022

	2021/22 %	**3 years Annualised %**	**5 years Annualised %**	**10 years Annualised %**
abrdn	27.7	9.2	7.2	7.5
Aviva	35.9	11.9	10.3	8.4
Blackrock	21.3	7.6	7.5	7.8
Royal London	22.4	6.6	5.9	6.8
IPD UK PPFI All Balanced Median return	23.1	8.1	7.8	8.1

2.7 abrdn was ahead of the benchmark in the last 12 months and three years but underperformed the 5 year and 10 year benchmark. The key contributors were prime industrial and logistics assets. These make up a substantial part of the fund's overweight industrial position. Recent disposals and asset-management transactions have also contributed positively, together with the retail warehouse holdings. Offices, high-street shops and shopping centres remain detractors, with flat yields, reduced rental values and additional leasing and capital expenditure provisions dragging returns.

2.8 This 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 benchmark over all periods, and significantly in the last 12 months. The Fund has closed and is winding up with the manager looking to dispose of all property assets and return cash to investors. The Pension Fund received £32.2m as an interim payment from this process in January 2022. Up to 31 March 2022 the Fund had sold five assets and was marketing three more properties. The remaining five assets will be marketed in the future following the resolution of outstanding lease/tenant matters.

2.10 Blackrock was behind the benchmark in all periods, however, the Fund has a lower than average risk profile, low vacancy rates, strong tenant credit ratings, and has strongly diversified tenant and asset profiles.

2.11 The Fund seeks to outperform the average of similar institutional pooled vehicles by investing in a diversified range of property throughout the UK. The Fund focuses on sectors and geographies positioned to benefit from the structural drivers of future tenant demand while maintaining a core risk profile with an emphasis on income component of total return.

2.12 Royal London returns have underperformed against the benchmark in all periods. The Fund is in the second quartile over one year, and the fourth quartile over all other time periods. Industrials generated the best absolute performance but were behind the benchmark due to weak rental growth. Retail and offices showed outperformance, primarily driven by inward yield movement seen in the retail warehouse sector. Overall vacancy rates have fallen due to recent lettings in the industrial sector. Remaining vacant space in the offices sector is due to be refurbished over the coming year before being marketed.

2.13 The Fund continues to focus on maintaining income levels and managing costs while progressing with ongoing asset management projects.

Outlook

2.14 UK commercial real estate showed strong growth in 2021/22. All sectors rose, with industrials showing the strongest growth and hotels the weakest. Retail also continued to bounce back following the Omicron shock. In UK commercial real estate, the office sector is likely to face some major structural challenges ahead, with polarisation between the very best and the rest likely to become more evident in 2022/23. Inflationary fears and the debate around its transitory nature have been net positives so far. There is a degree of insulation from higher inflation due to the index-linked nature of rental income. Low borrowing costs and ample liquidity are also providing support to real estate valuations.

3. EUROPEAN BALANCED PROPERTY FUND

abrdn European Property Growth Fund – Unit Trust

3.1 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 abrdn to invest in Continental European property. A further commitment of €10m (£8.8m) was approved in July 2005. The Fund was offered the opportunity to purchase additional units in quarter one 2022 and committed a further €42m (£35.5m) to the Fund, this purchase was completed in June 2022. The purchase was funded by the cash received from the Aviva UK Commercial Property Fund which is being wound up.

3.2 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.

3.3 As at the 31 March 2022, the €15m (£13.2m) commitment had been fully drawn and the investment in the Fund was valued at £14.1m. Distributions of €6.9m (£5.6m) have been received.

4.0 PROPERTY VENTURES

4.1 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 2022

	Undrawn Commitments 31 March 2022 £m	**Market value of holdings at 31 March 2022 £m**
RREEF – Property Ventures Fund III	0.0	0.1
Igloo Regeneration partnership	0.0	0.2
Franklin Templeton European Fund of Funds	0.3	0.1
Franklin Templeton Asian Fund of Funds	2.8	0.2
Hearthstone Residential Property Fund II	31.3	5.6
Allianz Home Equity Income Fund I	24.0	5.3
Total Property Ventures	**58.4**	**11.5**

RREEF Ventures III Unit Trust

4.2 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 Fund has disposed of all properties and is in the final stages of wind-down. This involves the termination of all the fund structures and return of capital to investors. A final distribution was paid in March 2022 and the fund liquidated in April 2022.

4.3 Total distributions since inception to 31 March 2022 are £3.7m. The year end investment multiple (the value plus the distributions received, divided by the total capital committed) is 0.37.

Igloo Regeneration Partnership

4.4 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.

4.5 On 1 July 2017 the partnership entered into a 'wind up' period with assets being marketed for sale. All assets had been sold, but final liquidation of the fund is being held up by unresolved management and historic service charges preventing the closure of a subsidiary entity. As at 31 March 2022 the Pension Fund's investment value is £0.2m, 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

4.6 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. The Fund is in the liquidation stage with ten out of the eleven original investments having been disposed of.

4.7 At 31 March 2022 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 2022 since inception the internal rate of return (IRR) for the fund is -8.03%. 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

4.8 The Committee approved the investment in October 2007 of $25m (£21.1m), with $3.7m (£2.8m) available to be drawn down as at 31 March 2022. The Fund made a total of sixteen investments and by the end of March 2022 there is only one underlying investment fund with unrealised assets remaining in the fund.

4.9 The value of the Funds investment is £0.2m at 31 March 2022, 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 1.19, with an internal rate of return (IRR) of 0.15%. 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

4.10 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. By 31 March 2022 the Fund had acquired 52 residential units in nine locations including Preston, Derby and Southampton. Six further sites are in the acquisition stage.

4.11 During 2021/22 the Fund received £2.3m of returned contributions as new investors joined the scheme and paid over £1.8m, therefore, to date, contributions to the Fund are £5.7m. It is too early to report on performance of this Fund, but of the 52 units purchased at the end of March 2022 34 units were occupied, the remain 18 were purchased in quarter one 2022 and 12 of these were let by 31 March. 98.10% of rent had been collected and no rent arrears have been written off.

Allianz Home Equity Fund

4.12 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. By 31 March 2022 scheme had funded 10 properties and had a further 51 under offer.

4.13 During 2021/22 £6.0m was drawdown by this Fund. It is too early to report on performance of this Fund

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).

Table Six: Infrastructure holdings as at 31 March 2022

	Undrawn Commitments 31 March 2022 £m	**Market value of holdings at 31 March 2022 £m**
Innisfree PFI Continuation Fund II	1.8	9.7
Innisfree PFI Secondary Fund	1.4	16.8
Innisfree PFI Secondary Fund 2	0.7	9.0
Infracapital Greenfield Partners I	4.4	12.5
Pantheon Global Infrastructure III	4.5	11.2
Total Infrastructure	**12.8**	**59.2**

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 purchased £0.5m from the investor commitment of BAE Systems Pension Fund and in 2021/22 purchased a further £1.3m from a Canadian Pension Scheme.

5.4 This Fund consists of assets acquired 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.

5.5 The investment is currently valued at £9.7m and has distributed £8.3m to 31 March 2022 (with a further £0.3m distributed in April 2022 relating to the six month period up to the end of March 2022). The portfolio of investments is forecast to provide a long term gross IRR of 11.0%, a long term net IRR of 8.4% and a 10 year average net yield of 7.8% before future optimisation.

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 2022, 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 £11.1m to 31 March 2022 (with a further £0.9m distributed in April 2022 relating to the six month period up to the end of March 2022). The portfolio of investments is forecast to provide a long term gross IRR of 11.6%, a long term net IRR of 8.3% and a 10 year average net yield of 9.3% 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 10 limited partners and 2 co0investment vehicles. The Fund had committed £449.1m to 24 projects and 82.5% of investor commitment had been cash drawn at 31 March 2022. All 24 projects are operational. 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 £9.0m. The drawdown period of the partnership ended on 28 March 2020 and the follow-on investment period on 28 March 2021. The Fund has distributed £4.8m to 31 March 2022 (with a further £0.7m distributed in April 2022 relating to the six month period up to the end of March 2021). The portfolio of investments is forecast to provide a long term gross

IRR of 11.7%, a long term net IRR of 9.6% and a 10 year average net yield of 12.4% 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, £5.8m was invested into these infrastructure schemes: £1.8m in Infracapital Greenfield Partners I and £4.0m 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 £1,043m 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 £12.5m, with outstanding commitments of £4.4m. It is too early to report on performance for this fund.

Pantheon Global Infrastructure III

5.15 The Committee approved a $21m (£15.9m) 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) and has made 39 commitments over the last four years. The fund is currently 104.3% committed with 69.5% of investors commitments drawn.

5.16 The pension fund's investment is currently valued at £11.2m, with outstanding commitments of \$6.0m (£4.5m). It is too early to report on performance for this fund.

6. FUTURE INVESTMENTS – PROPERTY AND INFRASTRUCTURE

Border to Coast – Global and UK Property

6.1 Border to Coast are currently in the build phase of their global and UK property sub-fund offerings. The time required for the development of these sub-funds is long given the complexity of unwinding existing property holdings, the cost of transacting in property and the illiquid nature of these assets. Current estimates are that the global sub-funds will launch in Q1 2023 and the UK property sub-fund towards the end of 2023.

6.2 It is anticipated that the Pension Fund will transfer the current allocation to UK commercial property into the Border to Coast UK property sub-fund and the European asset holdings into the global sub-fund. At the meeting in October 2021 the Committee approved a long term strategic allocation to the Border to Coast Core Global Property sub-fund of up to 50% of the overall property allocation. Therefore, in addition to the European asset holding being transferred into the global property sub-fund it is likely that the Pension Fund will allocate uninvested cash to this sub-fund to address the underweight position in property.

Infrastructure

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. At the Committee meeting in June 2022 the Committee approved a change to the Morgan Stanley mandate to increase its focus on private market investments, including infrastructure assets. The Pension Fund will continue to manage its current infrastructure investments. All new infrastructure commitments will be made through the Morgan Stanley Alternatives mandate.

Conclusion

7.1 Overall, the Pension Fund’s investment in property generated a return of 23.21%, which was ahead of the benchmark return of 19.82% (as measured by Northern Trust). Within this there is significant a significant variation in performance.

7.2 The property allocation, at 7.3% is underweight its benchmark allocation of 10.5%, however, the commitments to the two new UK residential property investments plus the launch of the Border to Coast global property sub-fund later in the financial year should help to address this over the next couple of years.

7.3 Infrastructure generated a return of 12.45%, which was also ahead of the benchmark return of 6.00%.

7.4 Infrastructure allocation, at 2.0%, is also underweight its benchmark allocation of2.5%, however, there are undrawn commitments of £12.8m.

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 2022

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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