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

Report to:	**Pensions Committee**
Date:	**21 September 2023**
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 2023.

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 7.7%. The market value of holdings in property pooled vehicles at 31 March 2023 was £228.1m (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 1.8%. The market value of holdings in infrastructure pooled vehicles at 31 March 2023 was £66.8m (2.2% of the Fund).

1.4 The Fund's total property and infrastructure holdings as at 31 March 2023 are set out in table one over the page.

Table One: Market value of property and infrastructure holdings at 31 March 2023

Property Pooled Investment Vehicle	Market value of holdings at 31 March 2023 £m	Market value of holdings at 31 March 2022 £m
Balanced UK Commercial Property	140.5	193.8
Property Venture and Residential Property	42.1	11.5
European Property Growth Fund	45.5	14.1
Infrastructure	66.8	59.2
Property/Infrastructure Cash	0.3	0.5
TOTAL PROPERTY AND INFRASTRUCTURE	**295.2**	**279.1**

1.5 The performance of the property and infrastructure holdings during 2022/23 was as follows:

- UK Commercial Property Unit Trusts return in the year saw an under performance, returning -18.20% against a benchmark of -14.49%;
- Other Property (including the European Property Fund, Property Venture and Private Residential Sector) saw a significant underperformance, returning -4.57% against the benchmark of 7.00%; and
- Infrastructure saw a significant out performance, returning 13.41% 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 -14.49% (IPD UK All Balanced Fund Index), over the twelve months to 31 March 2023, compared to UK equity returns of 2.92% (FTSE All Share) and UK index-linked bond returns of -17.76%.

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 just under half of the Fund's property and infrastructure holdings (47.6% of holdings as at 31 March 2023). 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 at 31 March 2023

	Market value of holdings at 31 March 2023 £m
abrdn – Trustee Investment Plan	66.6
Aviva Pooled Property Fund	9.3
Blackrock – UK Property Unit Trust	39.1
Royal London Exempt Unit Trust	25.5
Total Balanced UK Property	**140.5**

2.2 No additional investments have been made to the UK Commercial Property holdings during the year. The Pension Fund has received £19.4m from the Aviva Pooled Property Fund in the year, following the managers decision on 14 July 2021 to close the fund.

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 2023

Property Sector	Lincolnshire Fund %	IPD %	Difference %
Retail	19.9	18.8	1.1
Offices	16.6	24.0	-7.4
Industrial	40.7	37.8	2.9
Other	22.8	19.4	3.4
Total	**100.0**	**100.0**	

2.4 Overall, the Fund's property allocation, when compared to an index of similar property funds, is overweight industrials, offices in London, shopping centres, retail warehouses and other property. The Fund is underweight standard retail, and offices in the south east and the rest of the UK.

2.5 At an individual fund level:

- abrdn is overweight industrials and underweight offices in the south east and the rest of the UK.
- Aviva is significantly overweight retail warehouses and other properties. The manager is in the final stages of disposing of assets in the portfolio. At the 31 March 2023 there were just two assets remaining, a retail warehouse and a hotel, which is classified under other properties.

- Blackrock is overweight other properties (which includes primary care and student accommodation). They are underweight 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 a significant overweight position to 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.

Table Four: UK Commercial Property Investment returns to 31 March 2023

	2022/23 %	**3 years Annualised %**	**5 years Annualised %**	**10 years Annualised %**
abrdn	-20.0	1.9	0.8	5.0
Aviva	-26.2	1.2	1.3	5.3
Blackrock	-15.7	2.1	2.0	5.8
Royal London	-12.7	1.8	1.6	5.2
IPD UK PPFI All Balanced Median return	-14.5	2.6	2.5	6.4

2.7 Overall UK commercial real estate delivered returns of -14.5% during 2022/23 reflecting an unprecedented market correction in property values in the second half of 2022, following the strong growth seen in the previous financial year. Industrials were particularly hard hit, offices and retail were less affected and residential property showed the strongest performance. After this extremely sharp repricing commercial property values stabilised during the first three months of 2023.

2.8 It a manager level:

- abrdn returns have underperformed against the benchmark in all periods. Performance during last year was below the benchmark, which was due to the portfolio's relative overweight position to industrials which were more significantly affected by the reduction in asset values in 2022. The low-yielding nature of the portfolio also affected returns disproportionately, given the rapid increase in gilt yields and impact on property pricing. However, the final quarter of the financial year showed positive, and above benchmark, returns, helped by the sale of an office and car park investment, with significant vacancies, and the agreement of terms to sell two smaller assets.

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.

- Aviva has underperformed 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. By 31 March 2023 the Pension Fund had received £51.6m from the manager as the fund winds up and a further £7.1m in April 2023. At 31 March 2023 the Fund had just two assets remaining, a retail warehouse and a hotel. The sale of the warehouse completed in quarter one of 2023/24 and the hotel is under offer.

- 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. Similar to the abrdn portfolio, BlackRock is overweight industrials which were significantly affected by the fall in value seen in the second half of 2022. The fund saw a modest rebound in quarter one 2023 and outperformed the benchmark.

  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.

- Royal London was ahead of the benchmark in the last 12 months, but underperformed the 3 year, 5 year and 10 year benchmark. The fund is in the second quartile over one year, and the fourth quartile over all other time periods. During the last 12 months outperformance has come from income return and rental growth. The fund also experienced less outward yield movement compared to the index, this was helped by the fund being only slightly overweight industrials, which saw the most significant movement. The fund also benefits from a low void rate (5.8% at the end of March 2023, compared to the index average of 9.8%).

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

<u>Outlook</u>

2.9 UK commercial property asset values showed an average decrease of 21% from their peak in 2022, by March 2023 pricing was beginning to show signs of stabilisation. However, sentiment remains cautious and debt costs remain prohibitive. The UK market has repriced more quickly than other European markets and has therefore become increasingly attractive to overseas investors, however, this has not translated into an uptick in transactions, with investment volumes remaining subdued.

2.10 Occupational themes look to remain broadly unchanged. Significant restructuring of the retail sector since 2015 has created resilience among its occupier base and rents have rebased substantially. Limited supply of new high-quality space is supporting prime rents in the office sector, and a chronic undersupply of industrial and logistics space, coupled with resilient tenant demand has seen rents rise by 8.6% in these sectors over the last 12 months.

2.11 Across all sectors, a building's ESG credentials is now a critical consideration, as corporate occupiers seek to deliver on net zero carbon targets, with energy efficiency becoming a key priority.

2.12 Looking ahead, it is expected that there will be a gradual recovery in the UK commercial property market, mirroring the broader economic environment.

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 (£35.7m) 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 (44.7%) and distribution (42.9%) properties in the Eurozone, and to a limited degree in other European countries. The Fund is currently working with investors on a proposal to reposition the portfolio. This includes enlarging the types of property held within the portfolio by adding residential property, such as private rented sector, student housing and senior living, and redefining the assets which can be invested in within the alternative properties category, to include hospitality, healthcare, data centres and car parks. The fund is also looking to make some technical changes to the fund documentation to alter investor thresholds for approving material changes to the fund and how the fund is priced at entry and exit.

3.3 The investment is currently valued at €51.7m (£45.5m) at the 31 March 2023 and distributed £0.6m during 2022/23.

4.0 PROPERTY VENTURE AND RESIDENTIAL PROPRETY

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.

Table Five: Property Venture and Residential Property holdings at 31 March 2023

	Undrawn Commitments 31 March 2023 £m	Market value of holdings at 31 March 2023 £m
Allianz Home Equity Income Fund I	6.0	23.6
Hearthstone Residential Property Fund II	17.7	18.0
Igloo Regeneration partnership	0.0	0.2
Franklin Templeton Asian Fund of Funds	3.0	0.2
Franklin Templeton European Fund of Funds	0.4	0.0
RREEF – Property Ventures Fund III	0.0	0.1
Total Property Ventures	**27.1**	**42.1**

4.2 The Fund made investments into four property schemes between 2005 and 2007, Igloo, Franklin Templeton and RREEF, these are now in the wind-up phase. The Fund then made a further two commitments to residential property schemes with Hearthstone in 2020 and Allianz in 2021. The significant underperformance on property venture is explained by the timing of these commitments. The four original schemes are largely complete and are no longer generating significant income or capital growth (table six and paragraph 4.3 provide further details on these schemes). The two more recent commitments to residential property are in the early drawdown phase (paragraphs 4.4 to 4.7 provides further details).

Property Venture Funds

4.3 All these Funds are in the final stages of winding up, with the majority of assets having been disposed of and the small number of remaining assets being valued on a terminal (prudent) basis. Due to the timing of these investments, just ahead of the financial crisis of 2008, the performance has been poor and below original expectations. Table six, on the next page, sets out the original commitment value and timing along with the investment multiple returned by the funds.

Table Six: Original Property Venture Commitments and Investment Multiples

	Commitment Value	Commitment Date	Investment Multiple
Franklin Templeton European Real Estate Fund of Funds	€15m (£13.2m)	October 2005	0.62
RREEF Ventures III Unit Trust	£10m	January 2006	0.37
Igloo Regeneration Partnership	£10m	April 2006	0.77
Franklin Templeton Asian Real Estate Fund of Funds	$25m (£20.2m)	October 2007	1.00

Allianz Home Equity Fund

4.4 In March 2021 the Committee approved a commitment of £30m to the Allianz Home Equity Fund. The fund invests in existing residential properties on a shared ownership basis, whereby an individual owns a minimum of 5% of the property and the fund owns the balance. The individual pays 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 2023 the scheme had acquired 141 properties and had accepted offers on a further 88 properties.

4.5 During 2022/23 £18.0m was drawn down by this Fund. A further £6m was drawn down in quarter one 2023. Although it is too early to report on performance, in March 2023 the fund generated £155k in rental income and no tenants are in payment default.

Hearthstone Residential Fund 2

4.6 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 2023 the Fund had acquired 154 residential units in fifteen locations including Preston, Derby and Southampton. Two further sites are at the acquisition stage.

4.7 During 2022/23 £13.6m was drawn down by this Fund. Total return, year on year to quarter three 2022 was -0.8% (made up of income return of 1.1% and capital return of -1.9%). At this stage in the Fund's life, with only a small proportion of assets completed and are income-producing, the effect of transaction costs (particularly stamp duty land tax) have an adverse effect on returns. The capital return is also affected by stage payments on forward funded schemes under development. These temporary effects will be removed as the remaining assets are completed and handed over. At the end of March 2023 131 units were occupied and 3 were reserved. 94.75% of rents had been collected and no rent arrears have been written off.

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 seven).

Table Seven: Infrastructure holdings at 31 March 2023

	Undrawn Commitments 31 March 2023 £m	Market value of holdings at 31 March 2023 £m
Innisfree PFI Continuation Fund II	0.0	10.0
Innisfree PFI Secondary Fund	0.0	16.6
Innisfree PFI Secondary Fund 2	0.0	8.9
Infracapital Greenfield Partners I	2.2	16.8
Pantheon Global Infrastructure III	1.9	14.5
Total Infrastructure	**4.1**	**66.8**

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 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 £337.1m committed to 12 project investments, all of which are operational. Fund assets include: three hospitals, five education projects, three accommodation projects for the UK government and a Dutch high speed rail link.

5.5 The investment is currently valued at £10.0m and has distributed £9.7m to 31 March 2023 (with a further £0.3m distributed in April 2023 relating to the six month period up to the end of March 2023). The portfolio of investments is forecast to provide a long-term gross IRR of 11.2%, a long-term net IRR of 8.6% and a 10-year average net yield of 8.7% 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 2023, the Fund had total commitments of £590.0m to 33 projects, and around 98.3% 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 £16.6m, having distributed £20.0m to 31 March 2023 (with a further £0.7m distributed in April 2023 relating to the six month period up to the end of March 2023). The portfolio of investments is forecast to provide a long-term gross IRR of 11.8%, a long term net IRR of 8.5% and a 10-year average net yield of 9.7% 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 and 2 co-investment vehicles. The Fund had committed £449.1m to 24 projects and 82.5% of investor commitment had been cash drawn at 31 March 2023. 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 £8.9m. The Fund has distributed £10.7m to 31 March 2023 (with a further £0.6m distributed in April 2023 relating to the six month period up to the end of March 2023). The portfolio of investments is forecast to provide a long-term gross IRR of 12.0%, a long term net IRR of 9.9% and a 10-year average net yield of 12.6% 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 (£17.0m) to Pantheon Global Infrastructure III in February 2018.

5.12 During the year, £5.3m was invested into these infrastructure schemes: £2.2m in Infracapital Greenfield Partners I and £3.1m in Pantheon Global Infrastructure III. No redemptions were made.

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 potential 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. Discussions are underway with investors on the next phase of the fund’s life.

5.14 This fund has currently made commitments of £1,018.3m 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 £16.8m, with outstanding commitments of £2.2m. The portfolio of investments is forecast to provide a long-term gross IRR of 13.0%, a long term net IRR of 11.7%.

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. The fund is currently 105.1% committed with 89.0% of investors commitments drawn.

5.16 The pension fund's investment is currently valued at £14.5m, with outstanding commitments of £1.9m ($2.3m). The portfolio return on investment since inception at 31 March 2023 was 12.4% compared to a benchmark of 6.3% (50% US CPI/50% EU28 CPI plus 3% per annum).

6. FUTURE INVESTMENTS – PROPERTY AND INFRASTRUCTURE

Property

6.1 The strategic asset allocation to property is 10.5%. It was approved at the Pensions Committee meeting in June to adopt the following target allocations within this element of the portfolio:

- 30% to UK commercial property;
- 30% to UK residential property; and
- 40% to global property.

6.2 The Committee agreed that this would be achieved by:

- The Fund making new investments in one or two more residential property funds, managed by the Fund's current residential property managers, Hearthstone and Allianz, subject to due diligence; and
- The Fund will invest in the Border to Coast UK and Global Funds subject to due diligence.

6.3 In addition, the Fund will also considers exiting the abrdn European Property Growth Fund, subject to further discussions with the manager and due diligence.

6.4 These changes will be implemented over a period of years in order to manage the implementation costs and will be subject to the launch of the Border to Coast global and UK property funds which are still being developed. Current estimates are that the global sub-funds will launch in Q4 2023 and the UK property sub-fund towards the end of 2024.

Infrastructure

6.5 The Fund has a separate allocation to infrastructure, plus 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 Private Markets mandate.

Conclusion

7.1 The Pension Fund's total investment in property generated a return of -14.11%, which was behind the benchmark return of -10.36% (as measured by Northern Trust). Within this there is significant a significant variation in performance.

7.2 The property allocation, at 7.7% is underweight its benchmark allocation of 10.5%. This will be addressed by further allocations to UK residential property funds, and the Border to Coast global and UK property sub-funds.

7.3 Infrastructure generated a return of 13.41%, which was ahead of the benchmark return of 6.00%.

7.4 Infrastructure allocation, at 2.0%, is also underweight its benchmark allocation of 2.2%. Future commitments to infrastructure will be made by the Fund's private markets manager Morgan Stanley, and the strategic asset allocation adjusted accordingly.

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 2023

Background Papers

No background papers within Section 100D of the Local Government Act 1972 were used in the preparation of this report.

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