HYMANS ROBERTSON

Leicestershire County Council Corporate Asset Investment Fund

Strategy Review Paper

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For and on behalf of Hymans Robertson LLP

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1 Introduction

Addressee

This paper is addressed to Leicestershire County Council ("the Council"). It provides a strategic review of the Council's Corporate Asset Investment Fund ("CAIF" or the "Fund")

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Background

The 2018/19 Annual Report refers to the CAIF as fundamental to the economic, social and environmental wellbeing of the people of Leicestershire. The CAIF's income generated provides increased financial resilience to the Council's ability to deliver a comprehensive range of services in the future.

The strategic objectives agreed in 2018 are as follows:

- Ensuring a diverse range of properties available to meet the aims of economic development;
- Increasing the size of the portfolio;
- Improving the quality of the land and property available;
- Ensuring sustainability of the portfolios, replacing land sold to generate capital;
- Providing a revenue income stream to support ongoing service delivery.

The Fund is invested in both direct and indirect investments. To align the investments to the strategic objectives, the Fund is focused on the purchase of assets that deliver long-term income, with sound covenant and better than market yield, rather than a particular sector balance. The direct portfolio consists of property investments across the office, industrial, distribution and rural sectors and includes development properties. The indirect portfolio consists of six pooled fund investments: five UK property funds and one private debt fund. The Fund's benchmark is the MSCI Monthly All Property Total Return Index.

2 Market Background

General Economic Review

The onset of the pandemic has had a profound effect on financial markets so far this year. With populations across most of the developed world subject to lockdowns and/or strict social distancing measures, economic activity has suffered significantly with significant contractions in GDP experienced during the first half of the year.

Global GDP growth was slowing even before lockdowns aimed at stemming the spread of COVID-19 led to a plunge in activity in the first half of 2020. Q3 GDP releases showed the initial rebound in activity was sharp as major economies exited lockdowns. Even so, output remains well below end-2019 levels and high frequency activity data suggested a plateauing of the US recovery and a renewed downturn in the UK and Europe since the end of the Summer, even before the imposition of new restrictions. Output in most major advanced economies is not expected to reach pre-pandemic levels until 2022, at the earliest.

Inflation has fallen across most countries in the wake of the pandemic – headline UK CPI inflation fell from 1.7% to 0.5% over the period. The price of Brent crude oil fell by 38% over the period, with a nadir in Q1 being the lowest level seen since 2002.

The US Federal Reserve (the Fed) and the Bank of England cut rates to record low levels and the European Central Bank and Bank of Japan joined the Fed and the BoE in announcing large expansions of quantitative easing programs. The Fed's shift to "flexible" average inflation targeting likely means interest rate rises are even further away than previously envisaged.

Sovereign bond yields fell, reflecting the far more subdued outlook for growth, interest rate and inflation. 10-year US and UK government bond yields fell 1.0% p.a. and 0.2% p.a. respectively. Implied inflation, as measured by the difference between nominal and index-linked gilt yields of equivalent maturity, fell 0.2% p.a. to 3.3% p.a., as nominal yields fell more than real yields.

The UK economy has suffered one of the worst economic declines owing to the service-based economy. However, alongside the pandemic, the UK economy has faced the pro-longed Brexit uncertainty which, at the time of writing, remains unresolved. Sterling remains weak amid all this uncertainty.

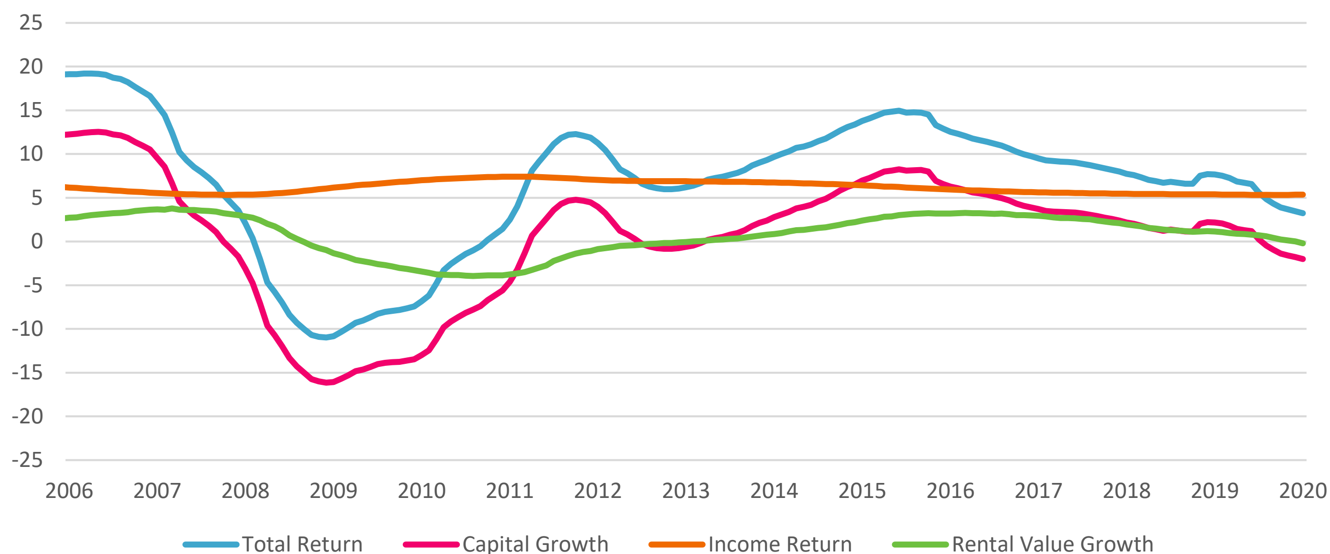
Property Market Review

Property has been one of the asset classes most negatively affected by the pandemic. There was a concern even pre-pandemic that elements of the commercial property market were in the downturn phase of a cycle. However, the timing of the pandemic means that a normal market cycle cannot be presupposed. In fact, the future of all sectors will be affected by the shape of the economic recovery, affecting recent and future performance.

The Bank of England indicated in August that it expects unemployment to reach 7.5% by the end of 2020, assuming a UK-EU trade agreement deal and extension of the furlough scheme. While there have been extensions to the furlough scheme, a trade agreement by 1 January 2021 remains uncertain at this stage.

Hence, relative to the Bank of England position, on the downside, there is therefore the potential for no EU trade agreement, a continuation of further national lockdowns to control pandemic waves, or if a vaccine is slow to be distributed.

Rolling 3 Year Returns of the MSCI UK Monthly Property Index (All Property 2006-)



Source: MSCI.

The chart above shows that the returns for the UK property market have been falling since early 2016. This includes both the total return and capital return which were on an upward trend until Brexit-related uncertainty caused both measures to trend downwards. The chart shows that despite the Brexit-related uncertainty, the stability of income has remained, with the income return remaining above 5% p.a. Rental growth has also been on a downward trend since 2016 reflecting the uncertainty that Brexit has had on the property market.

While this chart shows how the broad UK property market has performed, it masks significant sector divergence, with the industrial sector performing far stronger than the retail sector in particular which has been under significant structural change (we explore this later in this paper).

The UK property market saw an initial steepening of capital value falls in the early months of the pandemic, causing total returns to fall, although these have since moderated. Although all sectors have fallen, the retail sector has been the standout poorest performer so far this year.

We have included detailed reviews into the four main commercial property sectors (retail, industrials, offices and alternatives) as well as income-based property funds in Appendix A of this paper.

Forward-Looking Property Return Expectations

As is expected in times like these, any forecasts for economic growth are ever-changing in the face of changing expectations for economic recovery and potential lockdowns. The UK is now officially in a recession. In September 2020, UK GDP had recovered 16.0% above its low in April but still remained below Q4 2019 by some 8.6%. However, there are differing views, even within the Bank of England, as to how protracted the recovery will be amid assertions that some sectors may not fully recover.

For property specifically, capital values at an aggregate level fell through the first half of 2020. However, it is hard to base too much certainty about the outlook on these figures - the few transactions that have been completed have focused on prime, i.e. best in class assets, and there hasn’t been much of a move in pricing for these assets. The temporary protections such as government support, moratorium on evictions, and lenders overlooking covenant breaches has removed motivation for any stressed or distressed sellers. While there is some stability coming through in the data, it could be seen as a potential “false dawn” if there are more insolvencies and unemployment to come and, once transactions normalise, it’s likely that values will fall further.

Many property managers we have spoken to expect capital value declines to continue into next year, with CBRE predicting a total fall peak-to-trough across all property of about 15% over 11 quarters with the expected trough in the first half of 2021. This compares favourably to corrections in the past with the Global Financial Crisis peak to trough decline being 40% over 8 quarters and the 1990s correction which took 14 quarters and a value drop of 25-30%. This smaller peak-to-trough is mainly attributable to the monetary policy backdrop with low yields across the board.

With this unprecedented low yield environment, property yield spreads are relatively wide versus fixed income yields from a historical perspective. It is expected that this will give some support to values, suggesting less decline than seen in other market shocks.

With capital values likely to continue to face downward pressure well into 2021, total return expectations among those property investors brave enough to make forecasts over the next 3-5 years have low single digit returns for UK commercial property. Income returns should mitigate the declining capital values but we do not believe we have yet reached the bottom of the current property cycle. While rental growth had been broadly flat over the last few years, in mid-2019 this started trending downwards month-on-month. Void rates on the MSCI UK Monthly Property Index are also trending higher, driven by increased vacancies in the retail sector and are now above historical averages.

3 Portfolio Review

The table below summarises the Fund's portfolio as at 31 March 2020:

Asset Class	Value at 31 March 2020 (million)	% of Total Fund	Net Income Return (1 Year)	Capital Return (1 Year)
Direct Portfolio (inc. Dev.)	£125.8	73.6%	2.3%	0.1%
Direct Portfolio (exc. Dev.)	£67.0	39.2%	4.8%	1.3%
Offices	£27.2	15.9%	6.4%	-1.8%
Industrials	£12.4	7.3%	7.8%	-2.4%
Distribution	£0.5	0.3%	5.2%	-0.2%
Rural	£22.5	13.2%	1.2%	7.8%
Other	£4.4	2.6%	5.1%	1.6%
Development	£58.8	34.4%	-0.5%	-1.2%
Pooled Fund Portfolio	£45.1	26.4%	-	-
Property	£24.8	14.5%	3.9%	-3.0%
Private Debt	£20.3	11.9%	3.0%	0.7%
Total	**£170.9**	**100.0%**	**2.7%**	**-0.3%**

There are commitments that is forecast to see the value of the Fund's direct property portfolio grow substantially over the next three years.

We now provide comments on the direct and pooled fund portfolios within the Fund. We note that these figures are at 31 March 2020, which was shortly after the UK was plunged into lockdown. Valuers began placing material uncertainty clauses on valuations around this time so uncertainty existed on the capital values of the assets held by the Fund, both in the direct portfolio and the pooled property funds.

Direct Portfolio

Without having extensive details on each individual asset, we would state that the outlook for the Fund's office holdings will depend on the quality and location of each office. Those offices located close to good transport hubs, including motorways and train stations, are likely to perform better than those located in less desirable locations. Vacancy rates are rising within offices as the pandemic continues and valuers are taking a more aggressive stance on vacancies by assuming longer vacant periods, leading to a write-down in capital values. This may explain the -1.8% capital return over the year to 31 March 2020, although we would note that the office assets delivered a healthy net income return of 6.4%. We note that the Fund's capital return was impacted by a significant revaluation of its Embankment House asset.

The Fund's rural holdings have performed very well over recent years, largely driven by significant capital growth, and this continued over the year to 31 March 2020, with a capital return of 7.8%. Rural land prices have benefited from significant capital appreciation over recent years but according to Savills, the future path for rural capital values is less certain than in previous years. We expect increased regional divergence in performance so having assets in the right locations will be crucial in the Fund's rural holdings outperforming the wider market. The Fund has benefited from a £1.4 million increase in the valuation of Syonsby Farm.

The industrials sector has performed strongly over recent years, with yields plummeting. The Fund's industrials portfolio has performed differently from the wider market over the last year however, with a capital return of -2.4%, although the income return was strong at 7.8%.

We note that the fund has no exposure to retail sector assets which is a healthy position given the stress continued to be experienced in the sector.

Pooled Fund Portfolio

The fund has five pooled property fund investments, with the net performance of each fund over the trailing periods to 30 September 2020 (latest available) shown below alongside two representative UK property indices:

	1 Year	3 Years (% p.a.)	5 Years (% p.a.)	10 Years (% p.a.)
Aegon (Kames) Active Value Unit Trust I	-6.0%	2.1%	4.5%	-
Aegon (Kames) Active Value Unit Trust II	-1.3%	3.5%	-	-
Hermes Property Unit Trust	-2.6%	3.8%	5.8%	8.5%
Lothbury Property Trust	-4.2%	2.0%	3.7%	6.9%
Threadneedle Property Unit Trust	-2.7%	2.8%	4.3%	6.3%
MSCI AREF UK All Balanced Property Fund Index	-2.8%	2.6%	4.1%	6.4%
MSCI UK Monthly Property Index	-2.7%	3.2%	4.6%	7.6%

Source: MSCI.

We provide comments on each fund holding below:

- **Aegon Active Value Unit Trusts I and II** – both unit trusts are closed-ended vehicles with a strong value focus, looking to invest in higher yielding, multi-let UK commercial property. As these are closed-ended funds, the investments are representative of the opportunities available (and market conditions present) when the funds were deploying the capital raised. Both funds have completed their investment programmes by being fully invested.

  Active Value Unit Trust I was launched in 2013 and has just under 50% of its investments in the office sector, with the retail warehouse sector the next largest allocation at just over 20%. This has impacted recent performance with the retail warehouse allocations in particular seeing large write-downs. When compared to the wider market, the fund's relatively low allocation to industrials has proved a headwind to relative performance.

Active Value Unit Trust II was launched in 2016 and has a higher allocation to industrials (c.38%), the fund's largest single sector allocation. It is more diversified by sector, with significant allocations to offices and retail warehouses (c.30% and 21% respectively). This higher allocation to industrials is one of the main reasons for the outperformance of Unit Trust II over Unit Trust I over the last year.

- **Hermes Property Unit Trust** – the fund has been a very strong performer for many years and is well balanced across the main sectors. Hermes takes a very bottom-up approach so targets high quality assets located in areas with strong fundamentals. Consistently strong stock selection has been a great tailwind for performance. The fund also allocated some investments to higher risk, more asset management intensive assets to generate higher returns and these have also consistently added value. The fund has appointed a new fund director but is backed by an extremely strong proposition at Hermes.

- **Lothbury Property Unit Trust** – the fund targets properties located in prime areas and has a reasonably high (c.30%) allocation to the retail sector, particularly prime high street retail in London. This has proved challenging amid the pandemic as rents have fallen in retail, resulting in significant write-downs in capital, although rent collection figures have remained high. We expect the fund to display defensiveness in "normal" downturns but the pandemic is causing unforeseen problems. We would expect the fund to emerge reasonably well once the pandemic eases and normal life resumes.

- **Threadneedle Property Unit Trust** – this is similar in style to the Aegon unit trusts held by the Fund in that it targets higher yielding UK commercial property, with the key difference being that the vehicle structure is open-ended. The fund is well balanced from a sector perspective and having nearly one-third of the portfolio in industrials mitigated some of the capital losses experienced by the retail and office holdings, as did the income return which is high. We expect value-focused funds to lag peers in stressed market conditions so we are comfortable with its performance over the last year. The fund recently changed its lead fund manager, something we are closely monitoring although we have no real immediate concerns.

From an overall portfolio perspective, the Fund's pooled property allocations display a good level of diversification by style. The Aegon and Threadneedle investments focus on value investments in secondary property which results in higher yielding properties, providing income to the Fund. The Lothbury investment is focused on the prime end of the market while the Hermes investment offers balance across sectors. It should be noted that given the closed-ended structure of the Aegon funds, these will wind down over time, although holding the Threadneedle fund means that the Fund will retain a value-focused allocation when that occurs.

Private Debt Investment

The performance of direct lending as an asset class over the pandemic has largely been sector-dependent with more cyclical sectors such as retail, restaurants and leisure suffering more from protracted revenue loss during various phases of lockdowns. While most businesses suffered an initial shock through the first wave of national lockdowns, more resilient businesses have seen a rebound in earnings in the months since. Managers with more cyclical assets in the portfolio have encountered more stressed or underperformance in the assets with instances of workouts and restructurings. The market for direct lending is now even more active as banks have retrenched further in the pandemic leaving alternative lenders with a broader opportunity set.

The Fund is invested in one private debt fund, Partners Group's Multi-Asset Credit (IV) 2017 Fund. The fund is in its harvest period and the fund maturity is in September 2023. The portfolio has 93 assets across 61 issuers and is well diversified by sector as at 30 September 2020. The net IRR is 4% which is expected to increase slightly as loans which are marked below par (due to active broker quotes) are repaid.

4 Strategic Proposals

Based on our analysis of the Fund's portfolio, we make a number of strategic recommendations for consideration for both the direct property and pooled fund portfolios. These are outlined below.

Direct Property Portfolio

We make a range of recommendations for the Fund's direct property portfolio, as outlined below:

Consider Increasing the Allocation to the Industrial Sector

The industrials sector has seen significant growth over the recent years and in what has been a difficult last few years for UK commercial property, the industrials sector has delivered the strongest returns (see Appendix A). This has been driven by logistics and distribution properties, particularly those located in areas close to major populations (e.g. towns and cities) with strong transport links (i.e. close to major motorways and airports). While the growth in online shopping has hit traditional high street retailers particularly hard, the internet has forced retailers to rethink their business models and distribution and logistics facilities are vital for retailers to have successful online business.

A lack of significant new supply of industrials property, particularly logistics and distribution facilities, has driven up prices and despite the inward movement in industrial property yields over recent years, we believe high quality property let to strong tenants will deliver attractive yields (and total returns) going forward. The sector delivered the highest proportions of rent collection this year as the pandemic raged on, highlighting its resilience.

We would encourage the Fund to consider increasing the allocation to industrial assets. Given Leicester's central location in England, its proximity to major motorways like the M1 and M6 and the large populations within the Midlands, we believe the fundamentals of the area are supportive to the industrials sector going forward. By making selective allocations to industrials, we believe the Fund would benefit from the potential for attractive capital growth and income returns from the industrial sector.

Make Selective Allocations to the Office and Rural Sectors

As outlined earlier in this paper, the outlook for the office sector is uncertain due to the unknown structural changes that the pandemic will likely have on the balance between office-based and home-based working once the pandemic is over. As outlined in Appendix A, we do not believe that offices will be disappear but we do expect a greater balance of working from an office and home and therefore the offices of tomorrow will have to reflect a likely change in requirements of their tenants. We believe that there will be greater demand for offices with more flexible spaces, including more collaborative areas such as breakout rooms. We expect Leicester to retain strong employment dynamics as the economy emerges from the pandemic so we would expect offices with good transport links, with good onsite amenities and those that are more environmentally friendly with strong credentials on carbon output and initiatives like recycling, to fare better than offices without such credentials.

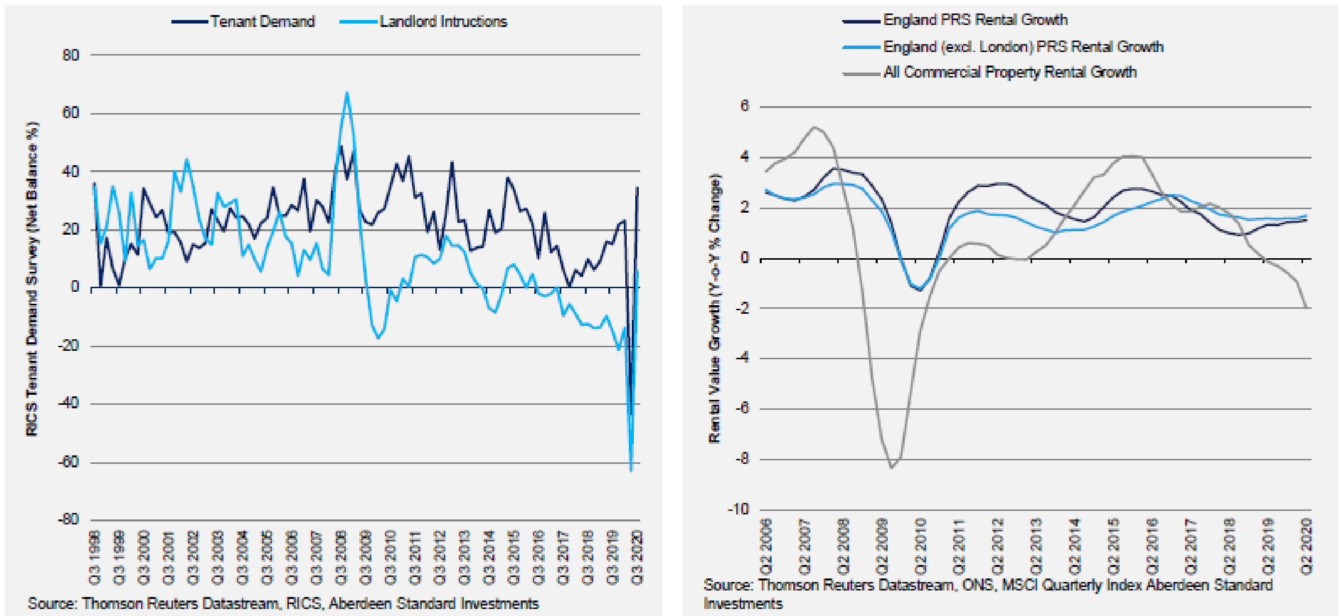
In addition to the office sector, we would note that Savills, a leading commentator on the rural property sector, forecasts that we are unlikely to see strong rises in rural land values over the coming years. The supply of rural land has been on a downward trend over recent years which is supportive of current prices, as is the expected demand for new land as the UK's population continues to increase. However, the outlook for the farming sector hinges on changes to current subsidies and the outcome of Brexit so caution should be exercised when investing in the rural sector.

For both the office and rural sectors, we would encourage careful selection of new investments as there is likely to be a greater dispersion in returns within each sector so asset choice and location will be critical in ensuring the Fund continues to invest in high quality assets in these sectors. We would advise against increasing allocations to both sectors.

Consider Investing in Residential Property

There is a structural imbalance in the UK housing market with a chronic shortage of supply caused by under-development and an increase in the population. People are renting for longer as it takes a lot longer to save a deposit to buy a house. According to a Government report in 2018, the number of households in the Private Rental Sector had doubled in 15 years, with 20% of households now residing in PRS. This is a demand trend we expect to continue, which will further support this nascent sector going forward and this strong demand supports attractive levels of rental growth compared to the UK commercial property market, as illustrated by the chart below:

Improved Demand is Driving Rental Growth within the Private Rented Sector



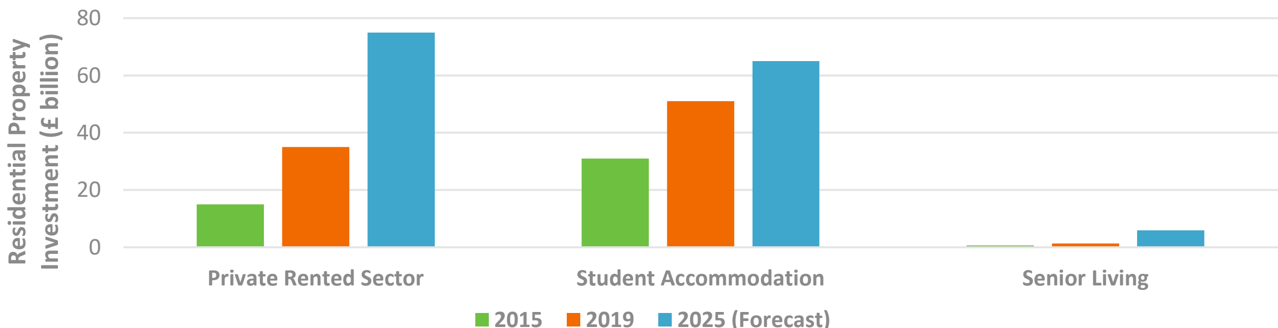
Source: Thomson Reuters Datastream, RICS, Aberdeen Standard Investments

Source: Thomson Reuters Datastream, ONS, MSCI Quarterly Index Aberdeen Standard Investments

We have seen the resilience of the sector during the pandemic and expect that it will continue to be the most resilient sector as people typically prioritise paying rent over other expenses regardless of their economic situation. Investing in the residential sector provides diversification to a commercial property portfolio and we consider it to be a good complementary investment.

Institutional investment into the residential sector has traditionally been low, although we expect this to change. The residential property market only accounts for just over 3% of the MSCI UK Monthly Property Index, although we expect this share to grow over the coming years. While the sector is still relatively difficult to access, as there is a national lack of supply and most investment will require some development risk, we are seeing focused strategies that sometimes blend an element of social housing as well. The chart below shows how the investment within parts of the private rented sector has grown significantly since 2015 and is projected to grow further:

Actual and Projected Growth in the Private Rented Sector



Source: Knight Frank

Returns vary according to the sub-sector of the residential market you are choosing to invest in, with higher returns available for the private rented sector (largely built-to-rent) compared to social and affordable housing which is subject to greater regulation. Investors will be required to invest at the construction stage in order to generate returns that are more comparable with historical UK commercial property returns as investing in purely operational assets will deliver returns many consider to be insufficient to make an allocation.

The following table summarises a breakdown of typical target returns for each tenure type from a selection of fund managers in the sector.

Target returns of various tenures

Tenure	Net income yield (p.a.)	Expected annual growth in income	Typical leverage (loan to value)	Targeted net return (p.a.)
PRS/Build to Rent	3-4.5%	c.3%	0-30%	6-7%
Student Accomm.	1-2%	5-6%	0-30%	6-7%
Senior Living	2-3%	5-6.5%	0-30%	6.5-8%
Social housing	2-3%	CPI +1%	0-30%	c.4.5%
Affordable renting	3%	CPI + / -1%	0-30%	5-6%
Shared ownership	4.5%	RPI +0.5%	0-30%	4.5-7%

Source: Hymans Robertson

We would recommend that the Fund considers allocations to the residential sector and could partner with developers in order to create high quality accommodation within the local area. If the correct locations and developers are selected, this has the potential to meet each of the Fund's strategic aims. In addition to the attractive income and returns on offer from the residential property sector, the ability to make a positive impact to the housing supply in the local area would likely be an attractive quality.

Pooled Fund Portfolio

There are a range of options available to the Council to alter the Fund's pooled fund allocations that would help it meet the overall strategic objectives. Some potential options are outlined below.

Evolve the Pooled Property Fund Portfolio

The Fund is currently invested in five pooled UK commercial property funds, three of which are open-ended (Hermes, Threadneedle and Lothbury) and two are closed-ended (both Aegon). The two closed-ended funds will return capital to the Fund over the next few years and in the absence of a buoyant secondary market for such diversified, value-focused funds, we would recommend the Fund allows the allocations to be wound down naturally. Instead of recycling this capital automatically into future funds with Aegon, we would recommend any decisions to be made with regards to the following recommendations around the structure of the pooled property fund portfolio.

While the three open-ended core balanced UK property funds offer good diversification relative to each other, we believe that the Fund does not require three such funds to achieve adequate diversification and instead could look to reduce the number of funds held to two. In light of the Fund's strategic aims, particularly its income requirement, we would recommend retaining an allocation to the Threadneedle Property Unit Trust due to its income focus. Of the two remaining funds, we have greater conviction in the medium-term and long-term

performance outlooks of the Hermes Property Unit Trust relative to the Lothbury Property Trust, particularly due to the latter's higher allocation to the retail sector which has choppier times ahead.

Rather than recycling the disinvestment proceeds from redemptions from one of the open-ended property funds into one or both of the other two remaining open-ended funds, we would recommend that the Council use these disinvestment proceeds to allocate to the areas outlined below (we would also recommend using the capital returned from the two closed-ended Aegon funds in the same manner).

Consider Investing in Residential Property Funds

As outlined in our review of the direct property portfolio, we believe the Fund should consider allocating capital to the UK residential property sector. While direct investments should be explored, the Fund could also make allocations to dedicated UK residential property funds. One of the key benefits of doing this is for the potential to benefit from either inflation-linked cash flows or through income from rents that will typically increase at levels close expected long-term inflation levels.

There are a number of open-ended and closed-ended residential property funds available in the market. Higher returns (and higher income levels) would be expected from the private rented sector, which is comprised of build-to-rent, student accommodation and senior living. Lower levels of income would be expected from investing in social and affordable housing, although the income available is typically contractually inflation-linked. In addition to providing income to the Fund, allocations to UK residential property would offer diversification benefits relative to the Fund's commercial property investments, both direct and via pooled funds.

Consider Investing in Impact or ESG-Focused Funds

ESG and climate change, particularly sustainability, are now firmly on the agenda in major real estate markets as investors look to manage climate change risks especially. The global transition away from fossil fuels and towards a low-carbon economy has significant impact on buildings, with Savills having estimated that real estate is responsible for almost 40% of energy and process-related emissions globally. Asset managers predict that it will become almost impossible to sell buildings that aren't climate friendly, requiring further investment to bring them up to standard. Highly efficient buildings can mean higher levels of operational performance, lower emissions and lower cost of capital.

Investors are also increasingly taking into consideration the social side of ESG. There is no denying that real estate plays a significant role in our lives and society; from houses and flats where we live to our workplaces, where we shop and locations where the things we use or buy are made or stored. There is, therefore, a real social impact of building in and around communities, from creating jobs to providing housing. Investors concerned with ESG can look to specific funds or strategies with either a focus on the environment or social impact, but it is worth noting that many asset managers are already integrating ESG within their core investment processes.

We would recommend that allocations to ESG or impact-focused funds should be explored. While there are no explicit ESG-focused objectives stated in the Fund's strategic objectives agreed in 2018, such allocations would offer an element of future proofing were formal ESG objectives introduced in the future.

In terms of our view of the responsible investment credentials of the Fund's pooled fund holdings, we rate each manager of the four property managers as 'Good' for responsible investment, while we rate Partners Group as 'Adequate' within private debt.

Increase Allocation to Income-Focused Asset Classes Outwith Property

The Fund currently has one pooled fund allocation outwith property, a private debt fund managed by Partners Group. The Fund should consider additional allocations, either to private debt funds or other income-focused asset classes. In particular, we believe allocations to core or core-plus infrastructure should be considered.

Infrastructure describes assets that societies require to function well. Infrastructure assets can provide high income streams with a long duration that can be linked in some way to inflation, either explicitly or implicitly. Clearly, this is of potential interest for investors looking for long term inflation-linked cash flows to match income requirements. Due to the monopolistic position that some infrastructure companies enjoy and the essential nature of the assets and services they provide, returns can be fairly predictable and resilient to market cycles. This can mean a low correlation of infrastructure with other asset classes and therefore good diversification for investors who can forgo liquidity.

The aim of investing in infrastructure will, therefore, typically be to access some combination of:

- further diversification of growth assets;
- reasonably high income distribution;
- a proxy match for longer term liabilities.

The nature of the investment can be chosen so as to prioritise one of these factors over the others. However, in practice, the investments available will involve some compromise relative to the ideal. Across various geographies, infrastructure comes in a wide variety of forms. There are two main categories of infrastructure assets (though it should be noted that not all of these opportunities will present themselves in all geographies and, where they do, it is possible that they can have varying risk/return characteristics):

- **Social** – for example, schools, hospitals and prisons. Revenues are typically dependent solely on the facilities being maintained and available for use; revenues will have little or no reliance on how much the facilities are used, and therefore little correlation with the wider economic environment.

- **Economic** – consists of assets that support commerce, and for which revenues are typically dependent on fees charged direct to the consumer (demand based). Example sectors and asset types are listed below:

  - Transport e.g. Bridges, Tunnels, Airports, Sea Ports, Rail and Mass Transport systems;

  - Communications e.g. Cable Networks, Broadcast and Communication Towers, Satellite Systems;

  - Energy e.g. Oil and Gas Pipelines, Power Generation, Gas Storage, Transmission and Distribution networks;

  - Environmental e.g. Water, Waste Treatment and Distribution, Waste and Recycling, Desalination Plants, Renewables.

Investing in infrastructure is very complex and costly to do directly so the easiest way for investors to access the asset class is through a pooled fund. There are a range of funds available but most target investments in economic infrastructure due the wider opportunity set and potential for higher returns. Funds also take varying levels of risk, with core funds investing in assets with far higher certainty over future cash flows due to a higher element of contractual income. The higher up the risk spectrum you venture, the lower the expected income return, although investors would expect to be compensated by a higher total return. Core-plus funds are predominantly invested in core infrastructure but typically allocate some portion of capital to higher risk investments that are currently less core in nature.

Renewable infrastructure has emerged as a stand-alone sub-sector within the energy and environmental sub-sectors of infrastructure over recent years. Renewable infrastructure investing is focused on the generation, storage and transmission of renewable energy, delivered largely by solar or wind-powered assets, although a range of new technologies also exists. Renewable infrastructure has been one of the most popular areas of infrastructure over recent years with investors attracted by the long-term cash flows on offer as well as the ESG

characteristics. However, the high prices being paid for existing renewable assets has driven down yields so institutional investors typically prefer investing in greenfield renewable infrastructure where assets are built then operated.

In terms of expected returns, we would expect generalist core-plus infrastructure funds that invest across a range of these different sectors (including renewables) to deliver high single-digit or low-double digit returns over the long-term, with a yield in the range of 4-6% p.a. Core-focused funds are expected to deliver a lower total return in the range of high single digits with a yield of around 4-5% p.a. For dedicated renewable infrastructure funds, we would expect returns for funds investing in existing assets to return 5-8% p.a., almost exclusively from income, while those that build then hold such assets are expected to return high single digit or low double digit returns, with income generated later in a fund's life once assets have been built and are operational.

We would recommend that due to the Fund's requirements for income, an allocation to core or core-plus infrastructure should be considered. Investments can be made in such funds via either open-ended and closed-ended fund structures and in addition to the attractive inflation-linked income on offer, such investments would be expected to provide diversification relative to the Fund's property investments.

A review of the performance of infrastructure during the pandemic is provided in Appendix B.

5 Implementation Considerations

The implementation considerations differ between the direct and pooled fund portfolios within the Fund.

Direct Property Portfolio

Hymans Robertson's research team is focused on both asset class and fund solutions to our clients. We do not have the level of in-depth knowledge on the fundamentals driving local property markets. Accordingly, we would recommend that a specialist property investment firm with a strong in-house research capability is employed to conduct a full and in-depth review of the Fund's direct property portfolio.

Such a review could identify current property holdings may not be suitable for helping the Fund meet its strategic objectives over the coming years. As part of this review, suitable local investment opportunities could be identified, particularly within those sectors we have recommended the Fund focus on.

Pooled Fund Portfolio

One of the key considerations for investors when investing in property is transaction costs. Unlisted UK commercial property is an expensive asset class to invest in, typically incurring high spreads of c.7-8% from entry to exit, largely due to stamp duty. While fund structure may increase the tax efficiency and reduce costs, investors should generally make allocations for the long-term and only invest if they are prepared to lock capital away for at least a full market cycle.

The development of the secondary market for property does allow more efficient trading of property to mitigate the transaction costs paid but unlisted property is an illiquid asset class so investors should be mindful of this and continue to treat property as an illiquid asset class. Investors looking to transition some or all of their current UK core commercial property portfolios into newer areas of the market should be mindful that it can take a number of quarters for capital to be drawn in the solutions outlined in the previous section so should plan accordingly.

Were the fund to consider reducing the number of investments in pooled open-ended property funds, opportunities to redeem via the primary market (i.e. directly with the investment manager) and secondary market (via the selling of units to another investor) should be explored to assess which would offer the Fund better value at that particular point in time.

We are aware that the Fund's pooled fund allocations have often been made in funds and managers that the Leicestershire County Council Pension Fund ("LCCPF") has invested with or in. This would open up a number of infrastructure and private debt funds and managers that the Fund could also invest in, although we would note that the LCCPF is not currently invested in residential property funds.

The Council could also seek additional advice on funds within each of the asset classes proposed in the strategic review, with fund recommendations provided following discussion of the return (particularly income) and risk requirements of the Fund to allow it to meet its strategic objectives.

6 Summary and Next Steps

Summary

In this paper we have reviewed the Fund's existing portfolio as well as conducting a strategic review on how it is positioned in the context of current market conditions. As part of our strategic review of the Fund's portfolio, we make the following recommendations:

- Future investment opportunities within the direct property portfolio should explore increased allocations to the industrial property, particularly in logistics and distribution assets. In addition, the fund should consider explicitly investing in residential property, particularly in the private rented sector and in social and/or affordable housing.
- Careful consideration should be taken for future direct property investments in the office and rural sectors in the Leicestershire area given the uncertain outlook for both sectors. We would caution against increasing overall allocations to both sectors.
- The structure of the pooled property fund portfolio should be considered with recommendations being to reduce the number of UK balanced commercial property fund holdings.
- Additional pooled fund investments should be explored in dedicated residential property funds, ESG-focused property funds and income-focused non-property asset classes, including private debt and infrastructure.
- We would recommend that the Council appoints a direct property specialist to review the existing direct portfolio as well as provide guidance on the sector and geographic-specific outlook in the local area. For the pooled fund investments, we also recommend that the Council takes further advice on the range of fund options that would meet the Fund's specific return and risk requirements.

This is summarised in the table below which summarises the Fund's portfolio at 31 March 2020:

Asset Class	Value at 31 March 2020	% of Total Fund	Strategic Recommendation
Direct Portfolio (inc. Dev.)	£125.8m	73.6%	
Direct Portfolio (exc. Dev.)	£67.0m	39.2%	
Offices	£27.2m	15.9%	Maintain or reduce
Industrials	£12.4m	7.3%	Increase
Distribution	£0.5m	0.3%	Increase
Rural	£22.5m	13.2%	Maintain or reduce
Other	£4.4m	2.6%	n/a
Development	£58.8m	34.4%	n/a
Residential Property	-	-	New allocation
Pooled Fund Portfolio	£45.1m	26.4%	
Property (Core Commercial)	£24.8m	14.5%	Decrease
Private Debt	£20.3m	11.9%	Maintain or increase
Residential Property	-	-	New allocation
Infrastructure	-	-	New allocation
Total	**£170.9m**	**100.0%**	

We are aware of a number of existing or planned developments over the coming years. This will impact the actual allocations in the table above so depending on the resulting residual changes, some prioritisation of our recommendations may be required.

Next steps

We would be happy to discuss the contents of this paper in more detail with the Officers should this be helpful.

General Risk Warning

Please note the value of investments, and income from them, may fall as well as rise. You should not make any assumptions about the future performance of your investments based on information contained in this document. This includes equities, government or corporate bonds, currency, derivatives, property and other alternative investments, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an investment. As a result, an investor may not get back the full amount originally invested. Past performance is not necessarily a guide to future performance.

Appendix A – UK Property Market: A Sector Review

Retail: All Doom and Gloom?

Coming into 2020, the wider UK property market performance was already being dragged down by the retail sector. In 2019 16,073 store units closed across the UK with over 143,000 total job losses. This trend has continued into 2020 with 13,868 stores closing and job losses numbering over 125,000 so far in 2020 (up to 1 September), with this number expected to increase to over 235,000.

The pandemic and lockdown have certainly exacerbated a crisis in retail, a sector already struggling with a combination of the shift of consumer behaviour to online shopping, a slowing of consumer spending since 2015 and fierce competition amongst retailers. The growing number of vacancies paired with the fact that investors are actively looking to reduce their retail exposure over the last few years has meant that capital values and overall performance of the sector has taken a significant hit.

Given the national lockdown when all non-essential shops were closed, it's no surprise that traditional retail is struggling. Rent collections in retail have been down markedly since March and estimates are that this will continue; although collection statistics vary across firms, Fitch reported three large property REITS collected between 16-36% of retail rents in June 2020, reflecting retailers having had essentially zero or drastically reduced revenues. With the recent extension of the moratorium on evictions until December, there is comment that some performing retailers deferring rents and landlords have little recourse in these situations.

Since shops have started reopening, some cities are seeing a rebound in fortunes. While in London there has been a decline of footfall with levels only reaching around 31% of pre-crisis as at September 2020, the pandemic has changed commuting patterns (and thus spending patterns), meaning that footfall in some smaller regional towns, such as Blackpool and Bournemouth, has actually increased to 141% and 133% of pre-pandemic levels respectively. The obvious uncertainty is whether this is a short-term catch up, and what will be the longer-term trend.

One change coming out of the pandemic is some renewed attention to turnover-based leases, which could help keep some retailers in business. Turnover-based leases see tenants pay rent based on their turnover and how sales perform. Certainly in this model, the landlord has a more active interest and becomes a participant in the store's outcome; while this might result in more volatile and cyclical income streams, we wouldn't expect the use of such leases to become commonplace and, as such, the overall impact to investors is likely to be muted.

On a broader note, uncertainty around retailer performance and rising vacancies across the country will likely add downward pressure to rents, a picture worsened by the macro elements: should unemployment increase considerably or there is prolonged uncertainty, consumer spending will be hit, which will mean further pain for the retail sector in general.

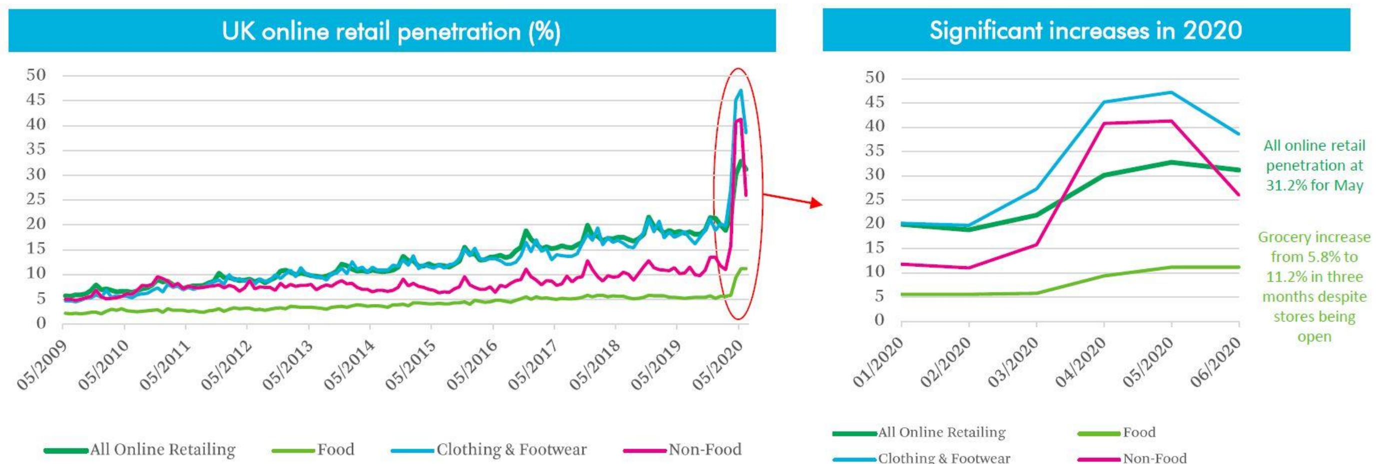
While the traditional retail picture is bleak, there are some potential brighter spots of retail that continue to attract investment. Essential retail, such as supermarkets, are well valued by investors for being typically long-term, inflation-linked leases. As supermarkets have stayed open throughout the pandemic, and even seen an uptick in revenue during lockdown as people couldn't eat out, this particular sub-sector has fared very well. Other asset managers are looking to the future shopping experience with large retail parks (referred to as retail warehouses) anchored by a supermarket or large, well-known retailer. These are expected to fare well as they are naturally better pre-dispositioned for social distancing with spacious, outdoor layouts and also potentially support greater integration of click-and-collect as there is floor space available for storage.

So what will happen with the abundance of vacant or distressed retail stock? If city centres wish to revitalise their high streets, the local councils will likely look to alternative uses for properties that could provide some regional office or residential supply to other sectors.

Industrials: Logistics and the Rise of Ecommerce

There has long been a rise in online shopping to the detriment of bricks and mortar retail. With the national lockdown affecting non-essential shops, this caused a massive spike in ecommerce activity as spending shifted online. Online ecommerce penetration jumped from 19% to 32% from February 2020 to May 2020 with a slight decrease since. Chart 3 below breaks this out by sector:

Chart 3 – The Growth of E-Commerce in the UK



Source: CBRE and the Office for National Statistics.

Logistics, a sub-sector of industrials, has been a popular allocation for investors for some time. In fact, the second quarter of 2020 saw a record take-up for UK logistics property, mainly driven by ecommerce-related functions. This is a spike in activity previously fuelled by tenants seeking to secure both larger warehouse spaces and smaller, “last-mile” facilities close to city centres.

According to Fitch, rent collection in the logistics sector for April-June was 95% with collection rates for “big-box” assets higher than urban warehouses with smaller tenants. This trend is augmented by investor demand for assets in such a resilient sector, which is pushing prices higher, particularly for large warehouses with prime tenants, such as Amazon, and investors need to be selective going forward. Although ecommerce could see a slight impact if consumer spending is reduced, this is not expected to dampen the enthusiasm or expectations for long-term logistics sector growth.

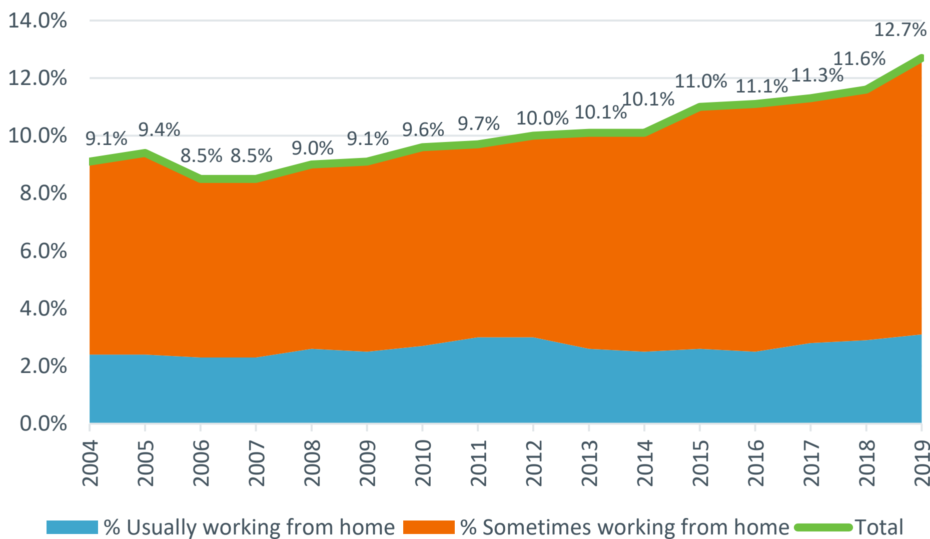
Offices: Working Hard or Hardly Working?

The trend of flexible, or remote working, and for more flexible co-working spaces had begun to grow in favour, in part due to the rise of tech start-ups across the country and the growing popularity of collaborative working spaces made popular by the likes of WeWork.

With lockdown forcing the vast majority of office workers to work from home, this trend has become the “norm”, and there have been many articles about the death of the office. While these concerns may be overstated, there has certainly been a sentiment shift amongst workers and companies are taking heed and re-examining their office space requirements

Pre-pandemic, employees who were working from home at least part of the time were a relatively small proportion of the workforce but had been growing as demonstrated in Chart 4.

Chart 4 – The Rise in Home Working



Source: Federated Hermes and Morgan Stanley Research.

A survey by Morgan Stanley has indicated a significant acceleration of this trend with all demographics and sectors indicating a preference to work from home more frequently in the future. There has been deterioration in sentiment for offices, with 93% of respondents to the RICS Q2 survey expect businesses to cut back on their office space requirements to some extent. A more recent survey by the Institute of Directors also reflects this trend with over 50% of executives planning to cut office space after the pandemic, with over 21% indicating this cut is likely to be significant. In addition, nearly three-quarters of the executive respondents indicated that they would encourage staff to increase working from home post-pandemic. This change of demand is set to change the dynamics of office sector, but we may not see the impact for a few years as companies are unlikely to break current leases and will make any changes at lease renewal stage.

However, we do not believe the pandemic spells the death of the office overall. The office remains important for both employers and employees. The office promotes cohesion, collaboration and brand recognition, and there is no question of the importance of the social aspect in this regard and the broader mental health wellbeing for most employees. However, office space originally marked for fixed desks may instead become more collaborative working spaces with increased hot-desking.

For investors, it is expected that location becomes even more important: well-located, best-in-class assets, with a strong ESG profile, will maintain the most robust valuations. However, as with all sectors, office demand could be affected by the economic recovery: a lack of economic recovery will likely lead to corporate insolvencies and increased layoffs and unemployment.

Alternatives: Mixed Fortunes

Alternatives is a catch-all sector for assets outside of the main three sectors: retail, office and industrials. Within alternatives, hotels and residential (typically purpose-built rental accommodation rather than individual houses and flats) are the most established sectors but there has been a more recent emergence of student accommodation and healthcare underpinned by similar fundamentals: changes in demographics, a rise in middle-class incomes and urbanisation.

Residential property has, by far, proven itself to be the most resilient sector during the crisis and this is no real surprise as it is expected that the population will continue paying for its housing costs whenever possible. The private rented sector (“PRS”) is a nascent sector in the UK but is quickly gaining traction, although there is very limited supply. Given the resilience and supply and demand factors, this will continue to be a sector of interest for investors going forward.

Other sectors within alternatives have had a much more mixed picture. UK hospitality has seen a bifurcation in performance. On the one hand, business hotels in city centres have suffered dramatically and have uncertain futures given the lack of business travel and the uncertainty over whether (or even if) business travel will normalise back to pre-pandemic levels. On the other hand, hotels positioned to take advantage of the UK boom in domestic holidays are performing beyond expectations.

Investment in student accommodation has risen over the last few years and one would expect the pandemic to cause challenges in this sector. While we may have expected the pandemic to have discouraged foreign students (or at least encouraged deferral of places), for high quality assets linked to red brick universities, there has been no change in performance. In fact, initial data shows lower than expected vacancy rates as universities have taken on more domestic students. A key question is the extent to which this persists.

With the healthcare sector, it remains to be seen how it will fare through the pandemic. While an ageing population had meant a rise in care homes and investment as a sector, the sector has suffered general reputational damage due to its handling of the pandemic and the fact that care home residents suffered more than the general population.

Income-Based Property

Long lease property funds invest in a subset of the UK property market, specifically targeting properties let to (typically higher quality) tenants on long, index-linked leases typically in excess of 15 years. Long lease funds have invested in a wide range of sub-sectors including supermarkets, leisure, offices, medical facilities, hotels and student accommodation, where the income stream is expected to be robust and sustainable. The resilience of these sectors throughout the pandemic has been mixed: given the long duration requirement of lease agreements, long lease property funds have avoided significant exposures to the troubled parts of the UK retail sector (high street retail and shopping centres) and have benefitted from exposure to supermarkets. However, exposures to hotels, leisure and student accommodation had the biggest immediate stress due to a fall in rent collections amid the lockdown enacted in March.

Commercial ground rents can be considered an extension of long-lease, with even greater value placed on the income rather than residual values. The main security for holdings, other than tenant quality, is the over-collateralisation provided through vacant possession values being greater than the value of the ground rents. While the pandemic has placed greater pressure on rent collection than long lease funds given exposure to leisure sector, this vacant possession value provides protection to valuations, so long as vacant possession values do not decline materially too.

We have explored many of these sectors above and to date rent collection on long lease funds has been stronger than the broader market, but it should be noted that the starting yield on long lease property is typically lower than for the broader property market (reflecting the expected security of income) and any tenant credit event can therefore impact the stability of future returns.

A reduction in broad market rents that leads to overrenting of long-lease properties will also affect residual values. Any reduction in rent collection and increasing concerns about the short-term prospects of some sectors that long lease funds target, predominantly leisure and student accommodation, means that the near-term outlook for long lease funds is uncertain as this pandemic continues, but we have greater conviction in the medium and long-term prospects of long lease funds compared to core balanced property funds.

Appendix B – Infrastructure Market Review

Market Performance

Infrastructure experienced negative total returns as the effects of the pandemic took hold. The EDHEC Infra300 Index, an unlisted infrastructure index, showed a total return of -9.4% over the year to 30 September 2020 (in sterling terms). This is over the market as a whole and masks significant sector divergences. The steep drop in valuations has been led by the sectors that have the greatest degree of economic sensitivity. Before we delve into examining the sector performance in more detail, it is worth noting how the economic sensitivity of infrastructure assets varies by sector. This is illustrated by the following table:

Sensitivity Level	Sector
High Economic Sensitivity	Ports Airports Toll Roads
Medium Economic Sensitivity	Railways Pipelines Renewables
Low Economic Sensitivity	Water Utilities Communications Social

As expected, the infrastructure sectors most severely impacted by the Coronavirus pandemic are those with the highest levels of economic sensitivity: airports; toll roads; and ports. These sectors are more economically sensitive because they offer services which are typically in less demand during economic downturns. The airport sector bore the brunt of the initial effects of the pandemic, with 90% of the world's fleet of passenger aircraft being grounded as countries imposed severe restrictions on personal freedoms. It is intuitive that there will be a drop in air and road travel as people tighten their belts while a reduction in global trade will see less sea trade. Sectors with low economic sensitivity typically have more stable revenues during economic downturns as the services they offer are much more essential and critical to the functioning of the economy. This downturn is obviously unusual in that there has never been such restrictions placed on personal freedoms but these relationships still remain true as this downturn progresses.

The airport sector has experienced the most severe initial impact of all the main infrastructure sectors due to the sharp drop in air travel. Airports rely on high passenger footfall to attract airlines to pay premium prices to operate services from while they receive commercial revenues from airport facilities such as retail and hospitality. With the levels of air travel falling off a cliff from March onwards, valuers have had to factor in reduced revenues received from airports as well as other material risks such as prolonged recoveries in passenger volumes.

Another sector which has experienced hardship of late is the ports sector. Ports have historically had the greatest levels of economic sensitivity as they involve the processing of shipping containers. Over 90% of global trade is conducted by sea and it is the most cost-effective means of transporting goods and materials around the world. With global trade plummeting, firstly in China then more broadly, the reduction in global trade means these ports are experiencing less volumes. It should be noted that global trade saw less of an immediate reduction from the pandemic than may have been expected and was already facing headwinds from the escalating trade war between the US and China. However, as the consequences of the economic damage inflicted by the virus take hold, economically sensitive sectors like ports remain vulnerable.

Toll roads are the final sector that have experienced steep declines in volumes. Will many countries in lockdown, road traffic volumes have plummeted, as have the road tolls received from drivers? This pain has been worse for those relief toll roads that benefit from drivers opting to pay to use them instead of using the more congested free roads. The longer that populations are subject to lockdown measures, the more prolonged pain likely to be experienced by toll roads.

While the majority of the market turmoil can be attributed to the Coronavirus pandemic, the dispute between Russia and Saudi Arabia that led to a collapse in oil prices has also impacted some energy infrastructure assets. Oil and gas pipelines are critical infrastructure and many funds are invested in the midstream energy sector which is involved in the transportation and storage of oil and gas. Lower oil prices, coupled with the reduction in energy usage from locked down economies has led to a reduction in oil and gas production so pipelines have experienced less volumes of usage. On a more positive note. there has been a boom in storage although this remains a small part of the energy infrastructure sector.

Sectors with lower economic sensitivity have generally performed better, as expected. Consumers still require the key utilities and although some will need assistance with payment plans, revenues should be relatively unaffected. The increase in home working brought on by the lockdowns heightens the demand for communications infrastructure, a structural trend that will only accelerate and strengthen. Finally, social infrastructure (hospitals, schools, prisons, etc.) remain unaffected by the current turmoil, with revenues usually dependent on making the asset available rather than on usage, with revenues ultimately backed by governments.

We noted earlier that the Coronavirus pandemic has reduced the demand for energy, causing electricity prices to fall. The vast reduction in pollution and emissions that we have experienced over recent weeks should also strengthen the tailwinds behind green energy. Renewable infrastructure is currently dominated by wind and solar assets geared towards the generation of electricity so while it has some cyclicality due to falling energy prices, this is mitigated by the offtake contracts in place, with only lower quality renewable assets exposing asset owners to market pricing risk.