By:	Chairman Superannuation Fund Committee Corporate Director Finance and Procurement
To:	Superannuation Fund Committee – 8 February 2013
Subject:	**INFRASTRUCTURE INVESTMENT**
Classification:	Unrestricted.

Summary: To set out the key issues around Pension Fund investment in Infrastructure and related assets.

FOR DECISION

INTRODUCTION

1. There has been a considerable amount of Government and media reference in the last 6 months to investment in UK Infrastructure by UK Pension Funds. This report sets out the latest position.

CURRENT POSITION

2. Members will be aware that the Fund already has a significant allocation to the Infrastructure asset class. Partners Group were appointed to a £75m Fund of Funds mandate in 2010.

3. Partners Group are a Swiss based partnership specialising in private markets investment management with total assets under management of €27bn. They have over 30 LGPS clients as well as leading UK companies such as J. Sainsbury plc, British Airways and BP. They invest through 3 main approaches:

   - Primary investments (45%) – investing in an infrastructure fund in its first 12-18 months fundraising period.
   - Secondary investments (32%) – buying an interest in a fund from an existing investor.
   - Direct investments (23%) – investments directly into companies both in the form of debt and equity.

4. Partners look for brown field infrastructure assets providing stable cash flows with the following characteristics:

   - Operational assets
   - Steady revenues.

- Regular cash yield.
- High spread over Government bonds.
- Low growth exposure.

5. They look to construct a very diversified portfolio of investments by type as set out in paragraph 3 above and by geography. The current programme is split as follows:

- Western Europe52%
- North America 22%
- Asia Pacific 21%
- Rest of World 5%

6. Hymans Robertson view this Fund of Funds approach as being the most effective way of a Fund such as Kent investing in the asset class despite the high cost of fees. One of the key challenges facing the market at present is to try and create an opportunity to invest in a more cost efficient manner.

UK DEVELOPMENTS

7. In November 2011 the Government published the new National Infrastructure Fund which was a strategy for coordinating and planning public and private investment in UK infrastructure. The report puts improvements in the UK's infrastructure at the heart of future economic growth as well as providing a stimulus to the economy. The report sets out the constraints on the ability of project sponsors to raise project finance debt from commercial banks. It says less about public funding but the Government has been highly critical of the previous PFI regime and deficit reduction restricts its ability to fund directly. The report highlighted the previous reluctance of institutional investors and pension funds in-particular to invest in infrastructure assets. It states the reasons for this as being:

- Limited capacity to assess project risks and make direct investments, as a result of which most pension funds tend to invest in infrastructure indirectly through intermediaries such as infrastructure funds or by buying shares or bonds in publicly listed utilities.
- The lack of clear benchmark for measuring performance of infrastructure investments.
- A shift in the future infrastructure pipeline to assets, such as infrastructure associated with a low carbon economy, that lie outside the risk appetite of many institutional investors.

- The report then announced a Memorandum of Understanding with the National Association of Pension Funds and Pension Protection Fund "to work together to help establish a platform to facilitate increased pension fund investment in infrastructure". Reference was also made to a group of pension funds including the Greater Manchester Pension Fund and the London Pension Fund Authority to develop proposals for investment in greenfield infrastructure. The Government targeted investment of £20bn through these routes.

8. In October 2012 it was announced that a group of the UK's largest pension funds including Strathclyde Pension Fund and West Midlands Pension Fund had come together as founding investors in the Pension Infrastructure Platform (PIP). The NAPF website refers to a fund of £2bn to invest in core infrastructure assets with target returns of RPI +2-5%.

9. In November the CLG announced a consultation on LGPS Investment in Partnership which rather spuriously has been presented as allowing Funds to increase their investment in Infrastructure.

10. In October 2012 the Future Homes Commission set up by the Royal Institute of British Architects published a report "Building the Homes and Communities Britain needs". This report identified a need for 300,000 additional new homes every year (three times the current level) and proposed a £10bn local Housing Development Fund financed and owned by local authority pension funds. The report states "this fund would be a cornerstone investor in local developments of sustainable mixed tenure communities across the country, particularly in our larger cities. Once these developments are mature they will be ideal investments for UK and international institutional investors, many of whom want to invest in UK residential property for rent, but are not about to take any development risk". The report seems to have identified local authority pension funds solely because they have money without any reflection on the liabilities the funds have to match. It refers to a return of 6-7% per annum, not unreasonable for mature projects but far too low for providing high risk development finance.

11. In November 2012 it was announced that the London Borough of Islington had invested £20m in the Hearthstone residential property fund. Hearthstone set the fund up earlier in 2012 and it is said to be the UK's only regulated residential property fund. The fund targets a return of 4% from income and capital gains from many residential property capital values which it estimates will reach 5% by 2017 A research note by Hymans Robertson on residential property investment is attached in the Appendix.

12. Locally senior officers at Ashford Borough Council and Maidstone Borough Council have approached the Head of Financial Services about investing in social housing and a senior officer from Thanet District Council enquired about infrastructure investment in Margate.

FUTURE APPROACH

13. A common theme of the initiatives set out in this report is that restrictions on borrowing from banks, the loss of confidence in PFI and Government deficit reduction has created a major funding issue for infrastructure investment. This has stimulated the promotion of investment by pension funds to fill this gap.

14. The stated aim of the Fund is to maximize investment returns for a given level of risk. The Fund has no broader "social" obligations. Therefore any Infrastructure investments need to stand as investment propositions alone when compared with the other asset classes on a global basis that the Fund is legally able to invest in.

15. A major theme for the Fund moving forward will be cashflow and the liquidity of investments. Major development finance for infrastructure is not liquid and for developed infrastructure funds may be run on an open or closed basis. The Fund does not have to have all its assets in liquid assets but it should earn a return premium for illiquidity.

16. In paragraph 7 the Government set out the reasons for the limited pension fund investment in infrastructure very well and development risk and project risk are fundamental to this. At a recent discussion panel including the Head of Financial Services the consistent theme from the local authority pension fund officers was that there are very limited investable opportunities currently in the UK in Infrastructure.

17. Any future approach to Infrastructure investing needs to meet the following criteria:

    - Well diversified – by geography and the sector invested in eg. housing, rail, roads, water.

    - Developed assets – even an organisation with the depth of resource that Partners Group has will not invest more than a small proportion of assets in development projects. Across all sectors the risk is much higher and major public sector projects have demonstrated a tendency to large cost over runs. This risk would not be compensated for in the returns received.

    - Secure income flows – predominately income flows need to be underwritten in some way by government or quasi government organisations.

    - Returns – for the overall return required by the Fund and to reflect the risk returns need to be high single digit or low double digit.

    - Management arrangements – potential investments need to have well proven management arrangements, managers with excellent credentials and a fully development commercial fund.

18. Any investment propositions can then be evaluated against these criteria.

RECOMMENDATIONS

19. Members are asked to:

    (1) Note this report.

    (2) Agree the criteria set out in paragraph 17.

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