Item 5

CT/13/42
Investment and Pension Fund Committee
13 September 2013

INFRASTRUCTURE STRATEGY

Report of the County Treasurer

Please note that the following recommendations are subject to consideration and determination by the Committee before taking effect.

Recommendation: **That the Committee approves an investment of €50million (c. £45million) into the First State European Diversified Infrastructure Fund, £20million into the Aviva REaLM Infrastructure Fund and £20million into the Aviva REaLM Ground Rents Fund.**

1. Introduction

1.1. At its previous meeting the Committee agreed to increase the target allocation to infrastructure from 2% to 4% of the Fund. The Committee asked for further information on potential infrastructure investments including the proposed investment in Aviva's REaLM Funds.

1.2. This report outlines the action that has been taken since the last committee, and proposes investments in the First State European Diversified Infrastructure Fund, and in Aviva's REaLM Infrastructure and Ground Rents funds.

2. Investment in Infrastructure

2.1 The key objectives in making a further allocation to infrastructure are:

- Improved diversification of the fund by investing in an asset class with low correlation to Gross Domestic Product (GDP). The high barriers to entry and monopolistic characteristics of many infrastructure assets mean that their financial performance is not as sensitive to the economic cycle as many other asset classes.

- Ability to enhance the Fund's long term returns without increasing overall risk. Infrastructure can provide a high level of return, including a high cash yield. The returns targeted need to be assessed in relation to the risk of the investment, including for example the risk of changes to the regulatory system under which the business is operated, the operational risk of managing the business, and refinancing risk where there is leverage involved in financing the business.

- Ability to improve our protection from UK inflation. Inflation is a key risk in relation to pension liabilities, and infrastructure can provide mitigation against inflation risk through the agreement of contractual price increases linked to inflation.

2.2 Other factors to consider in choosing an investment include the ownership and experience of the firm; the leverage used; the geographical/sector focus (especially %age in UK); target size and expected drawdown timetable; expected exit process (if any); investor base (inc commitment from parent); LGPS experience/clients; client service; and fees and structure.

2.3 Over the last few months, officers have looked at a variety of different infrastructure funds, and during the summer have met with six different managers with the Fund's Independent Advisor. The managers were asked to outline how their funds met the criteria as described in 2.1 and 2.3 above. On the basis of those criteria, two investments are proposed, as outlined below.

3 First State European Diversified Infrastructure Fund

3.1 First State Investments is the asset management business of the Commonwealth Bank of Australia, with a worldwide business and assets under management in excess of £100 billion. The European Diversified Infrastructure Fund (EDIF) has been formed to invest in infrastructure investments with a principal focus on mature, income generating economic assets based in Europe. First State are targeting a total fund size for the EDIF of £1.5billion.

3.2 From the Devon Pension Fund's viewpoint the key attributes of an investment in the First State EDIF are:

- A high targeted level of return – 10-12% net of fees over the long term, including a cash yield in excess of 5% per annum.
- A well diversified fund with assets held and proposed in different sectors and geographical locations.
- The Fund has already invested in four assets – Anglian Water (UK), Electricity North West (UK), Reganosa, a Liquefied Natural Gas (LNG) terminal in Spain and Digita, a leading provider of broadcasting tower infrastructure in Finland. These assets will be added to as the Fund grows, but the existing assets mean that we are not investing totally blind into assets yet to be determined, as we could be with other funds.
- A relatively short draw down period, meaning our cash should be fully invested within a reasonable timeframe.
- A long term fund – the Fund has an initial term ending in 2024. In 2019 investors will have the option of extending the Fund to 2029 by a two thirds affirmative vote, this process to be repeated at five year intervals if extension is approved. As a long term investor the Devon Fund can commit for long periods, and the long life of the fund will reduce the risk of a low return from the eventual sale of the assets, as a larger proportion of the return is taken from the annual income yield, and the five year period for the assets to be sold is a longer timeframe than with some of the other funds considered.
- Lower fees than some of the other funds considered, including only charging fees on drawn down cash, whereas some funds charge fees on committed funds yet to be invested.

3.3 It is proposed that an investment of €50million be made into the First State EDIF, which at the current exchange rate equates to around £45million.

4. Aviva REaLM Funds

4.1 Aviva Investors are owned by Aviva plc, the largest insurer in the UK, and currently manage the Devon Pension Fund's property mandate. Aviva have set up their REaLM (Returns Enhancing and Liability Matching) funds specifically for UK pension funds. There are four individual funds and a multi-sector fund. It is proposed that the Devon Fund invests in the Infrastructure Fund and the Ground Rents Fund.

4.2 The Infrastructure Fund focuses on renewable energy, with current/proposed assets including energy centres and solar PV cells, although other forms of infrastructure asset will be considered as the fund moves forward. The Ground Rents fund currently focuses on residential ground rents linked to the Retail Prices Index (RPI). Aviva currently have around £1.2billion of investor capital committed to their REaLM funds.

4.3 From the Devon Pension Fund's viewpoint the key attributes of an investment in the Aviva REaLM Funds are:

- They are UK focused funds with target returns specifically linked to UK inflation. The REaLM funds are the only funds of those considered with a specific link to UK inflation, and are therefore the best mitigation for inflation risk.
- The inflation linked target returns are lower, estimated at around 8-9% for the infrastructure fund and 7-8% for Ground Rents. However there is also a lower risk, as all assets are bought outright, with no leverage. All other funds considered employed a significant degree of debt financing in relation to their individual assets.
- Lower risk also as a result of the long term amortising nature of the funds. The infrastructure fund assets will operate for 25-30 years, and the Ground Rents fund involves leases of 100+ years. The returns will be generated from income received from the assets, removing the risk associated with realising a capital value from the assets at the end of the Fund's life.
- A staggered draw down period, with the Infrastructure Fund investment likely to be drawn down within six months and the Ground Rents investment likely to be drawn down by the end of 2014.
- Lower fees than all the other infrastructure funds considered.

4.4 It is proposed that £20million be invested in each of the Infrastructure and Ground Rents funds, making a total investment of £40million.

5. Conclusion

5.1 The proposed infrastructure investments will complement each other, and the existing investment in the UBS International Infrastructure Fund. The proposed investment will result in the Devon Fund having an allocation to a global fund, a European fund and a UK fund, with different levels of risk, being reflected in different target levels of return. This will provide a well-diversified portfolio, and bring the infrastructure allocation up towards the target level over a period of around 18 months.

Item 5

Mary Davis

Electoral Divisions: All
Local Government Act 1972
List of Background Papers – Nil
Contact for Enquiries: Mark Gayler
Tel No: (01392) 383621 Room G97