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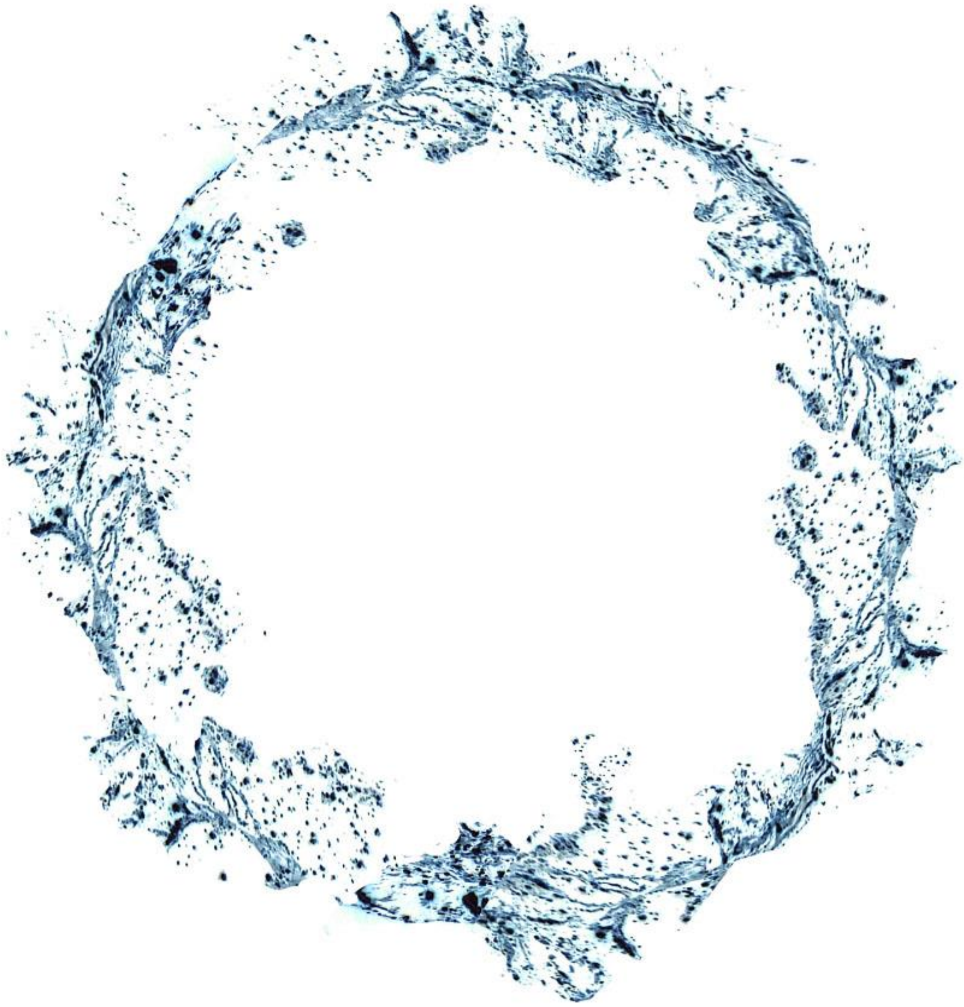

London Borough of Hammersmith & Fulham Pension Fund

Infrastructure Equity – Market Considerations

Deloitte Total Reward and Benefits Limited
August 2022

Introduction

This report has been prepared for the Pension Fund Committee of the London Borough of Hammersmith & Fulham Pension Fund ("the Fund") for discussion at the 7 September 2022 Pension Fund Committee Meeting. The purpose of this report is to discuss the parameters and characteristics required from an infrastructure allocation to replace the current outgoing allocation to the Aviva Investors Infrastructure Income Fund ("AIIIF").

At the 20 June 2022 Pension Fund Committee Meeting, the Pension Fund Committee agreed to proceed with the proposed full disinvestment from the Fund's investment in the Aviva Investors Infrastructure Income Fund ("AIIIF") and, in June 2022, the Pension Officers served notice to fully disinvest from AIIIF with the proceeds expected to be received over the 12 months following the accounting date of 31 December 2022. Aviva Investors and the Jersey Manager, RBC, continue to progress the redemption process and expect to make the Fund's units in the AIIIF available to other existing investors in due course.

Intended characteristics of the current allocation

The key objectives behind the Fund's initial investment in the AIIIF was to deliver an investment return with a focus on inflation linkage and income. The AIIIF invests entirely in UK-based assets on an unlevered basis. While the fund was not labelled a renewable infrastructure fund, the majority of assets were in the renewable energy sector. The fund has a gross target distribution yield of 7-8% p.a. (which equates to a net of fees distribution yield of c. 6.5-7.5% p.a.) with approximately three-quarters of the revenue stream linked to UK inflation.

As market conditions have changed, it is unlikely the same characteristics can be replicated without altering factors (e.g. leverage, development risk etc). It should be noted that a significant factor in the decision to disinvest from the AIIIF was that the performance targets, in particular the cashflow yield, was not being met.

Given this allocation was made in 2017, the characteristics should be reassessed to consider whether this remains appropriate to the Fund's needs in current market conditions. This should also be considered as part of the wider investment strategy and 2022 actuarial funding valuation.

Market developments

With the significant increase to inflation, investing in "real" assets which offer a degree of inflation-linked income streams have become more attractive and therefore in higher demand, driving yields down to some extent. Interest rates have also increased which is likely to impact on the cashflow delivered from assets that have particularly high leverage.

Renewable infrastructure assets has also experienced increased investor demand given the greater focus on ESG and the predictable long-term yields on offer. There has also been an increase in demand for UK-based projects as energy supply issues resulting from the Russia / Ukraine war has placed even greater emphasis on the UK's need to build 'homegrown' sustainable and reliable energy production.

Considerations

The Committee should discuss the characteristics which are of most value from this allocation. In particular, thought must be given to the level of income required and the extent to which this income is needed in the near term. Some questions for discussion have been outlined below:

Characteristic	Points to discuss
Return requirement	5-7% is a reasonable expected return from infrastructure (with Renewables perhaps slightly lower). Factors such as leverage and greenfield/brownfield as well as regional exposure will have an impact on expected return.
Cashflow requirement	Brownfield assets will deliver cashflow much earlier than greenfield. Open ended funds will typically deliver cashflow earlier than closed ended, provided there is an existing portfolio of assets.

Leverage	Higher leveraged assets will increase the return requirement but reduce the predictability of income, with interest rates potentially having an impact.
Importance of inflation	Should this be direct UK RPI/CPI or regional inflation (noting there would be some correlation).
Renewables	This sector has seen increase demand from investors although governments continue to ask for private investment to grow this sector. With the European Commission proposing that constituent countries cut gas usage by 15% (largely to wean itself off Russian gas), this will stimulate further requirement for 'homegrown' energy.
Development risk	Greenfield assets will typically deliver higher returns, although it may take longer for money to be deployed and cashflow to be generated. Pressure on supply chains has put increased risk on costs and likelihood of delays, possibly impacting IRRs.

This discussion should be done alongside the training session that will take place before the 7 September 2022 Pension Fund Committee meeting. The table in the appendix outlines managers that are currently raising funds and have been considered as potential replacements for the AIIIF allocation.

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