

Getting your ducks in a row: how can real assets income solutions help the LGPS meet the income challenge?

**James Sparshott**

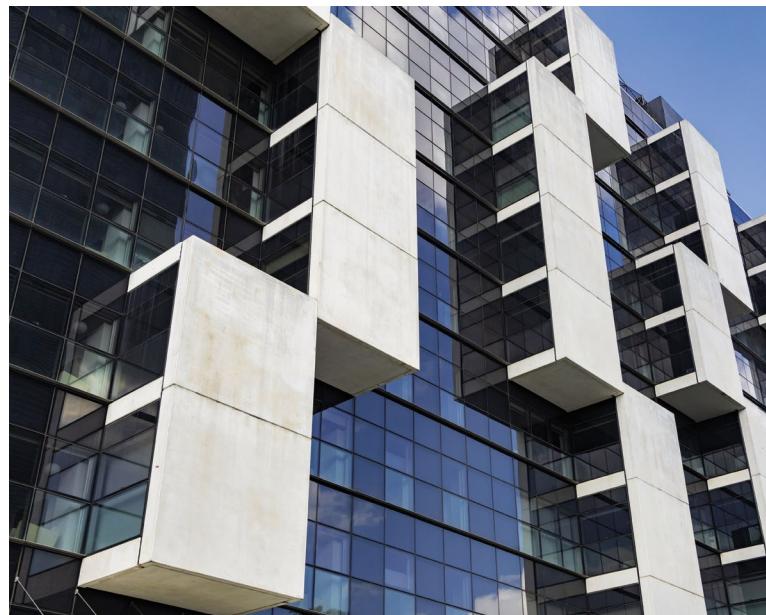
is Head of Local Authorities within distribution, where he is responsible for managing and developing relationships with LGIM's LGPS clients.

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The LGPS is reaching a tipping point – the search for assets that offer resilient income alongside attractive and sustainable returns is ever more pressing. Not only is inflation beginning to gather steam, but if the previous 10 years have taught us anything, it is that there will be bumps along the road. The last thing that schemes want to be worrying about when a financial crisis hits is what assets they need to sell to pay pensions each month.

LGIM's Real Assets Income Solutions seek to deliver long-term, stable income through contractual cashflows from high quality private debt and property assets, to help you pay pensions while generating sustainable returns. These assets aim to offer



diversification, lower volatility and an investment premium versus traditional public market allocations, alongside inflation linkage and a natural fit with the sustainable investment objectives of the LGPS.

Striking a balance

LGPS investment priorities are shifting as the membership profile evolves and the world around us changes. While in aggregate the LGPS is still cashflow positive after investment income, employer contribution growth is not keeping pace with benefit payments from the expanding pensioner population. By March 2020, already 34 out of 100 funds were cashflow negative, even after allowing for investment income.¹ At the same time, the LGPS is leading the way in shaping best practice in sustainable investing and balancing engagement with action in helping to address the climate crisis.

To deliver their overarching objectives of affordability and stability, we are seeing funds prioritise both sustainability and income when making investment allocation decisions. We believe that the cashflow profiles, risk and return attributes and ESG credentials of LGIM's Real Assets Income Solutions could help the LGPS meet these objectives.

Secure Income Assets*			Long Income Property
Corporate Debt Lending to companies who are seeking borrowing outside public markets	Infrastructure Debt Financing a range of infrastructure projects such as transport, energy and digital	Real Estate Debt Providing senior loans secured against commercial property (including offices, industrial, build to rent)	 Properties with long-term contractual rental agreements linked to inflation

¹ Source: MHCLG, <https://www.professionalfpensions.com/news/4025823/lgps-negative-cashflow-2024>

*Secure income assets ('SIAs') identify cashflow outcomes from illiquid private asset classes, where the income stream often benefits from a range of contractual protections that enhance asset owners rights to maintain expected cashflows (for example, covenant protections, specific security or ring-fenced collateral). The contractual protections of a particular asset will depend on these terms and the financial strength of the counterparty. SIAs are held with the aim of producing a predictable income stream - this income stream is not guaranteed and there is no underwriting of income provided to the Fund.

Seeking to deliver resilient income alongside attractive and sustainable returns

Secure Income Assets*

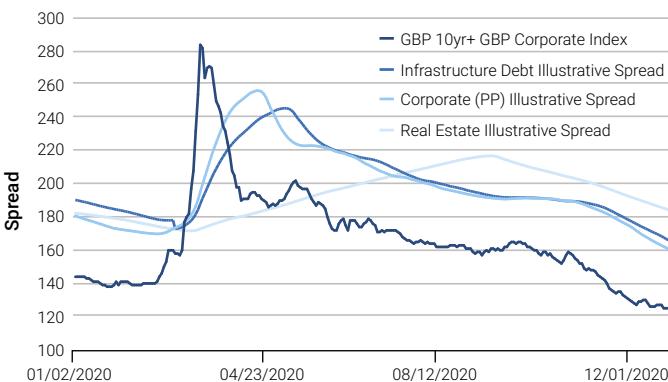
Secure income assets incorporate structural protections which can help to strengthen income resilience and downside protection compared with public credit. These include seniority in the capital structure, potential security over physical assets (e.g. real estate or infrastructure), and additional covenants.

Covenants are obligations to maintain certain credit metrics and restrictions on incurring further debt, and may also include specific ESG criteria. We can use covenants in our secure income asset investments to hold borrowers to account where we are allocating capital to support companies in meeting specific sustainability objectives – for example, commitments on the use of proceeds when financing the refit of a car plant to enable the production of electric vehicles and maintain jobs in the local community.

Secure income assets can also offer an investment premium to compensate for the less liquid nature of the investment which (including adjustment for structural protections) can range from 30bps to 120bps versus public credit – for example, LGIM's portfolio has delivered a long-run average of roughly 55bps.²

Our Secure Income Assets Solutions offer a straightforward way for investors to gain exposure to these asset classes, either through our multi-asset Secure Income Asset Fund, or through individual funds specialising in particular areas of the market (such as infrastructure debt). The relative value of private corporate debt, infrastructure debt and real estate debt varies significantly through time as can be seen from the Figure 1, which gives an indication of the kind of relative market movements we witnessed during 2020. This could, we believe, argue for a multi-asset approach.

Figure 1: The relative values of secure income assets vary significantly



Source: LGIM, 2021. Indicative figures. For illustrative purposes only.

PP = private placement

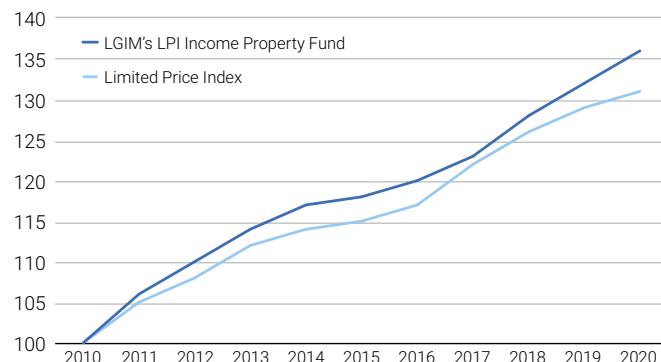
2 Source: LGIM, 2021.

3 <https://fundcentres.lgim.com/uk/en/fund-centre/PMC/LPI-Income-Property-Fund/>

Long Income Property

We believe long income property assets offer a compelling opportunity for LGPS funds looking for income: they generate a durable and long-term income stream backed by long-dated leases with high quality tenants, and they benefit from regular income increases that are linked to inflation. This is particularly attractive for the LGPS where pensions are increasing in line with inflation, and in light of the wider inflationary risks on the horizon as we make our way through 2021. For example, LGIM's LPI Income Property fund has over 95% of its income linked to inflation and has delivered income growth well in excess of LPI over the last 10 years, as shown in Figure 2.

Figure 2: Consistent income growth in excess of LPI over last 10 years



Cumulative income growth. Source: LGIM, 31 December 2020. Past performance is not a guide to the future.

The returns on long income property are also usually significantly less volatile than traditional property investments because they are driven by the income, rather than the value of the property at the end of the lease (which tends to make up less than 25% of the value in the LPI Fund). LGIM's LPI Income Property fund has delivered more than 8.1% p.a. (as at Q1 2021) in returns since inception in 2010. Historical performance can be found on our [Fund Centre](#).³

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Case study 1: Sustainable returns and responsible investing

LGIM's Real Assets Income Solutions offer an integral alignment with the ESG objectives of the LGPS. We offer long-term financing to support companies advancing their sustainability agenda, and our real estate business is

committed to a pathway to net zero by 2050. We put ESG at the heart of the investment process to mitigate risk, drive change and hold borrowers and tenants to account, as shown in the examples below.

Secure Income Assets*	Long Income Property
<p>Electrification of UK car manufacturing</p>  <ul style="list-style-type: none"> • Long-term debt financing • Guaranteed by parent company and interest wrapped by UK Export Finance • AA- rated credit • Use of proceeds delivers strong social/environmental benefits • Finance will be used to get plant ready to manufacture electric cars with 70% to be exported to Europe • Plant directly employs c.8,000 people and indirectly creates a further 4,000 jobs in the sector - financing will be used to keep UK plant open and maintain employment 	<p>Freeman's Reach, Durham - a sustainable development</p>  <ul style="list-style-type: none"> • High quality single let office building • Let to Durham County Council for 35 years • AA rated covenant • Successful relationship established during Phase I led to Phase II • Regeneration of a key site within Durham City Centre incorporating exemplar sustainability credentials • A+ EPC rating and BREEAM rating of Excellent • Hydropower turbine providing asset's own clean energy source

Case study shown for illustrative purposes only. The above information does not constitute a recommendation to buy or sell any security.

Performance during the pandemic

LGIM's Real Assets Income Solutions give LGPS funds an opportunity to get their ducks in a row when it comes to income. March 2020 was a clear example, where the severe market stress made it expensive to sell assets both in terms of trading costs and, perhaps more importantly, the fact that assets had to be sold at depressed levels (which was even more painful, given the rapid rebound in asset prices).

Our Real Assets Income Solutions weathered the storm with strong income in the face of unprecedented circumstances. We saw no income interruption across our Secure Income Assets portfolio, with no impairments or downgrades, or across our Long Income Property portfolio, with 100% rent collection (including forbearance) during 2020 and credit quality maintained at BBB or above.

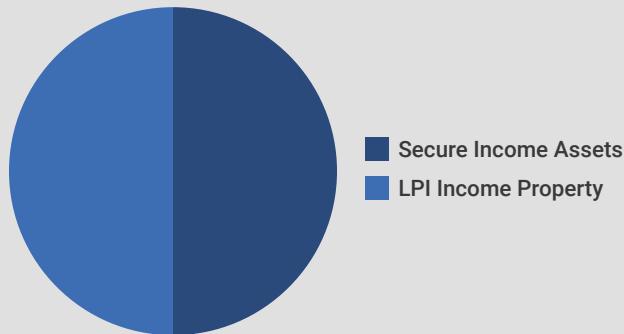
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Case study 2: Complementary cashflow profiles

The cashflow profiles for our Secure Income Assets Solutions and Long Income Property fund are complementary, with Secure Income Assets focused more at the shorter end and Long Income Property more at the longer, including inflation linkage.

Combining complementary Real Assets Income Solutions

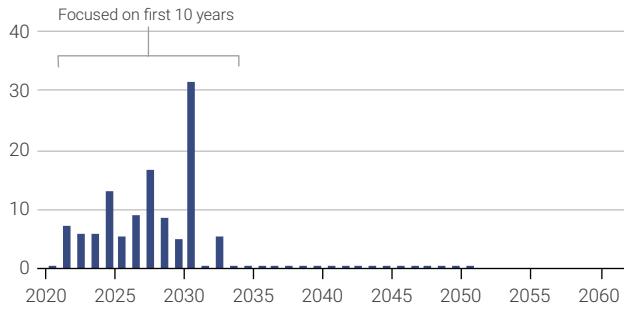
Example allocation



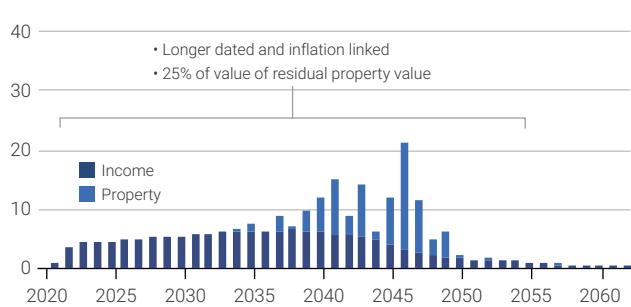
- Diversified sources of long-term, stable income
- Current return expectation of gilts + 3.25% p.a.*
- Coverage across the term of liability profile
- Income delivery aim of 3.5%+ p.a., with half linked to inflation

Illustrative cashflow profiles**

Secure Income Assets



LPI Income Property



These solutions are available within LGIM's standard pooled fund range and are therefore easy to access, without complex legal and drawdown arrangements. Our Solutions team have a wide range of tools to analyse your scheme's starting point and model potential solutions, taking account of your scheme's cashflow requirements and the income received from other assets.

* Based on current portfolio and prevailing market conditions

** Based on £100m investment

Source: LGIM Real Assets 2020. For illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

how we could help build a solution tailored to your specific circumstances.

Key risk

The value of an investment and any income taken from it is not guaranteed and can go down as well as up; you may not get back the amount you originally invested.

Conclusion

For LGPS funds looking to develop a more robust income strategy, we believe LGIM's Real Assets Income Solutions can play an important role by targeting long-term, resilient income that helps schemes to pay pensions while aiming to generate sustainable and attractive returns. There's no time to waste in getting those ducks in a row with Real Assets Income Solutions, and LGIM is here to help. Please contact us to see

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative



Important information

Past performance is not a guide to future performance. The value of an investment and any income taken from it is not guaranteed and can go down as well as up; you may not get back the amount you originally invested.

Please note, the case study is for illustrative purposes only. Reference to a particular security is on a historical basis and does not mean that the security is currently held or will be held within an LGIM portfolio. The above information does not constitute a recommendation to buy or sell any security.

Views expressed are of Legal & General Investment Management Limited as at July 2021.

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