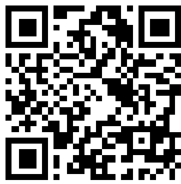

Leicestershire County Council

Meeting: **Investment Subcommittee**

Date/Time: **Wednesday, 23 March 2016 at 10.00 am**

Location: **Gartree Committee Room, County Hall, Glenfield**

Contact: **Mr. M. Hand (Tel. 0116 305 6038)**

Email: **matthew.hand@leics.gov.uk**

Membership

Mr. G. A. Hart CC (Chairman)

Cllr. D. Bajaj	Mr. P. C. Osborne CC
Mr. K. W. P. Lynch CC	Cllr. M. Graham
Mr J. Shuter	Mr. N. Booth

AGENDA

Item		Report by	
1.	Minutes of the meeting held on 14 October 2015.		(Pages 3 - 6)
2.	Question Time.		
3.	Questions asked by members under Standing Order 7(3) and 7(5).		
4.	To advise of any other items which the Chairman has decided to take as urgent elsewhere on the agenda.		
5.	Declarations of interest in respect of items on the agenda.		
6.	Increase In Infrastructure Weighting.	Director of Corporate Resources	(Pages 7 - 10)
7.	Date of Next Meeting - 27 April 2016.		

8.	Any other items which the Chairman has decided to take as urgent.	

Exclusion of the Press and Public.

The public are likely to be excluded during consideration of the following items in accordance with Section 100(A)(4) of the Local Government Act 1972 (Exempt Information):

9.	Infrastructure Investment - Presentation by J P Morgan. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager
10.	Infrastructure Investment - Presentation by KKR. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager

Agenda Item 1

Minutes of a meeting of the Investment Subcommittee held at County Hall, Glenfield on Wednesday, 14 October 2015.

PRESENT:

Leicestershire County Council

Mr. G. A. Hart CC (Chairman) Mr. P. C. Osborne CC

Leicester City Council/District Council Representative

Cllr. P. Kitterick
Cllr. M. Graham

Staff Representative

Nick Booth

University Representative

Mr. J. Shuter

Independent Advisers and Managers

Mr. A. Green Hymans Robertson

89. Minutes of the previous meeting.

The minutes of the meeting held on 24 July 2015 were taken as read, confirmed and signed.

90. Question Time.

The Chief Executive reported that no questions had been received under Standing Order 35.

91. Questions asked by members.

The Chief Executive reported that no questions had been received under Standing Order 7(3) and 7(5).

92. Urgent Items.

There were no urgent items for consideration.

93. Declarations of interest.

The Chairman invited members who wished to do so to declare any interest in

respect of items on the agenda for the meeting. No declarations were made.

94. Emerging Market Backdrop.

The Investment Subcommittee considered a presentation by the Fund's financial advisors, Kames Capital, which provided background information on emerging market investments. A copy of the presentation is filed with these minutes marked '6'.

RESOLVED:

That the presentation be noted.

95. Schedule of future meeting dates.

RESOLVED:

That meetings of the Subcommittee be held on the following dates in 2016:

Wednesday 23 March
Wednesday 27 April
Wednesday 22 June
Wednesday 20 July
Wednesday 10 August
Wednesday 12 October
Wednesday 14 December

96. Date of Next Meeting - 9 December 2015.

It was noted that the next meeting would be held on 9 December 2015.

97. Emerging Markets Fund - Presentation by Delaware Investments.

The Subcommittee received a presentation by representatives of Delaware Investments which was followed by questions from members. A copy of the presentation is filed with these minutes marked '9'. The presentation was not for publication by virtue of Paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

a) That the presentation be noted;

b) That it be noted that the Subcommittee continued to have concern with regards to the performance of the Delaware Emerging Market investment and that managers representing Delaware be requested to attend a meeting of the Subcommittee in Autumn 2016 to provide a further update on their investment performance.

Wednesday, 14 October 2015

10.00 – 11. 35am CHAIRMAN

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INVESTMENT SUBCOMMITTEE – 23RD MARCH 2016

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

INCREASE IN INFRASTRUCTURE WEIGHTING

Purpose of the Report

1. To propose a method in which the Leicestershire Pension Fund could invest the additional 2% (c.£60m at the current Fund size) of total assets in infrastructure that was agreed at the January 2016 Annual Strategy Meeting of the Local Pension Committee.

Background

2. Until the January Strategy Meeting the Fund had a 3% target weighting in infrastructure assets, and its actual investment is currently 2.7%. There is, however, $45m of committed capital that has not yet been ‘drawn’ by the Fund’s existing infrastructure managers (KKR and IFM) and it is expected that the Fund will reach its original target weighting within the next six months.

3 Within asset classes such as infrastructure it is virtually impossible to maintain a weighting that is exactly in line with the target as it is necessary to make assumptions about what will happen in the future – for example there is no way of having any certainty about when individual assets will be sold and the proceeds returned to investors, so commitments to the asset class need to plan for the prospective return of capital in advance.

4. The majority of infrastructure funds operate on a ‘blind pool’ basis. In broad terms this involves a manager receiving commitments from investors before they have sourced the investments, and ‘drawing down’ the commitments on a gradual basis as the investments are actually made. This is the model employed by KKR, with whom the Leicestershire Fund has committed to both the KKR Global Infrastructure Fund ($56m committed in 2011, now 93% drawn) and KKR Global Infrastructure Fund II ($30m committed, 11% drawn but with a number of deals close to finalisation).

5. The more unusual type of infrastructure fund is one that is open to new investors. In this type of fund investors commit monies and are held in a queue until assets are purchased that require the capital to be drawn. When the commitment is drawn the investor gains exposure to not only the asset that its capital has purchased, but also to all other assets that are already within the fund. This gives investors more visibility on what they are buying, and also a more mature infrastructure portfolio than is normal within a ‘blind pool’. The IFM Global Infrastructure Fund is an open infrastructure fund, and Leicestershire made a $56m commitment to it in late 2011 with all the capital being invested in a single drawdown in early 2013. In September 2015 the Fund agreed a further $15m commitment which is, as yet, undrawn.

6. The combination of the three infrastructure funds in which Leicestershire has an investment gives the Fund exposure to 26 different infrastructure assets that are well diversified by sector and geography. This number will increase as further drawdowns within KKR II occur.

7. There are many attractions of infrastructure, including potentially strong generation of cash flows and these cash flows are often linked to inflation. From an investor's perspective, however, the best infrastructure investments will inevitably be those that are purchased at the right price, where the manager takes action to improve the operational performance of the asset and where an exit can be achieved in a competitive environment. The ability to source investments at a reasonable price and the willingness to 'stand back' when competition for individual assets pushes prices up to high levels are key skills.

Strategic increase in infrastructure weighting

8. At any point in time there are a number of infrastructure funds raising capital from investors, and there is often a long lead- in time to the deployment of capital (i.e. actually getting monies invested, rather than making a commitment that will be drawn at a later stage). The Fund could carry out an exercise to assess all the managers that are currently raising funds and assess their abilities, but it is likely to be two years or more before any significant element of the extra monies that are now available would actually be invested. Whilst this is a better option than making bad investments quickly, officers and the Fund's investment consultants have first assessed the capabilities of the Fund's existing investment managers (both those that are employed to manage infrastructure and those that currently manage other asset classes). Having carried out this assessment it is believed that there are opportunities to implement the increase in weighting in a timely and sensible manner.

9. IFM, one of the Fund's existing infrastructure managers, has an open infrastructure fund that Leicestershire could commit to. There is already a $15m commitment awaiting drawdown, and it is considered unlikely that any further commitment will be deployed within an acceptable period of time. IFM do not offer co-investment opportunities (see paragraph 10) unless a fund has considerably more capital to deploy than Leicestershire has.

10. KKR have raised two closed-ended funds and while fundraising for a third will commence in due course, the second fund is only 11% drawn and capital for the third fund will not be invested until the second has been fully committed by the manager. Although the KKR 'pipeline' for deals looks healthy and as a result there may soon be a significant increase in the pace of drawdowns, the first actual investment for a third fund is still some way off. KKR do, however, offer co-investment opportunities and this is something that is considered attractive to the Fund.

11. When KKR identifies an investment opportunity for its closed-ended funds, the size of the investment will occasionally be too large for them to put the whole of the investment into the fund – a $1bn investment for a $3.1bn fund would, for example, lead to an over-concentrated portfolio. When this occurs they seek co-investors to buy a share of the asset. It would be possible for the Leicestershire Fund to utilise

these co-investment opportunities as-and-when they come along; all of these investments will be ones that KKR consider worthy of inclusion within their pooled fund.

12. If the Fund were to utilise co-investment opportunities with KKR there will be a ‘doubling up’ of the investment – the Fund would gain exposure to the asset in an indirect manner via the KKR pooled fund, and also directly via the co-investment. It could be argued that this gives an over-exposure to a single asset but when the Fund’s overall exposure to infrastructure assets (i.e. the existing 26 that will grow in number) is taken into account, the overall infrastructure portfolio will remain very well diversified.

13. In order to invest the £60m increase in infrastructure weighting in an optimal manner, it is not deemed feasible to only use co-investment opportunities with KKR. They will present their co-investment proposals to the Investment Subcommittee (ISC) at today’s meeting and, subject to the ISC being comfortable with this, it is suggested that 1/3rd of the extra monies are ‘set aside’ for future KKR co-investment opportunities with the aim of making 4 – 6 investments in this manner. Whilst this portfolio of co-investments might look overly concentrated when judged on a stand-alone basis, the reality is that it is just one part of a diversified overall exposure to infrastructure assets.

14. JPMorgan, who currently manage a bond portfolio for the Fund, have an open infrastructure fund that has performed consistently in recent years and is highly regarded by the Fund’s investment consultant. Furthermore, it has shown the ability to deploy capital in deals that are ‘off-market’ and do not require an auction process. Their queue of commitments is currently low and they continue to seek opportunities that, if concluded, are likely to lead to timely deployment of any commitment. They have fourteen existing assets spread across thirteen countries within their $5bn fund.

15. Attached as an appendix is a report by the Fund’s Investment Consultant which provides a more detailed analysis on the JPMorgan Infrastructure Investments Fund, and the manager will present their credentials to the ISC at today’s meeting. Subject to the views of the ISC, it is considered sensible to commit £40m (c. $60m) to this fund.

Possible future structure of infrastructure investments

16. If the currently available £60m is invested on the basis of £40m with JPMorgan and £20m in co-investments with KKR, the resulting portfolio will be well diversified and would look as follows:

IFM	£52m
KKR (pooled)	£61m
KKR (co-investment)	£20m
JPMorgan	£40m

17. These values assume that the IFM and KKR (pooled) commitments are fully drawn, and on this basis total infrastructure assets would be valued at £173m (or 5.6% of current total Fund assets). In reality the first KKR infrastructure fund is expected to have distributed further sale proceeds before the second fund has been fully drawn

(two distributions from sales within KKR I have already been made), and it may actually be necessary to commit further monies to infrastructure in the future.

Summary

18. The suggested method of deploying the c.£60m new commitment to infrastructure (via co-investments with KKR and a commitment to the JPMorgan Infrastructure Investments Fund) should ensure that the capital is deployed quickly and with high quality managers. The resulting position of the Fund's total infrastructure holdings will be very well diversified.

Supplementary Information Informing the potential additional investment in infrastructure

19. Exempt presentations by JP Morgan and KKR informing the potential additional investment, which are of a sensitive nature, are included as items 9 and 10 on the agenda.

Recommendation

20. The Investment Subcommittee is asked to consider new investments in infrastructure assets via co-investment opportunities with KKR and the JPMorgan Infrastructure Investments Fund.

Appendix

Infrastructure Options - Report by Hymans Robertson

Equal Opportunities Implications

None specific

Background Papers

Local Pension Committee 23 January 2016 – Strategic Investment Benchmark

http://cexmodgov1/Published/C00000740/M00004490/AI00046598/$StrategicInvestmentbenchmark.docA.ps.pdf

Officers to Contact

Colin Pratt, Investments Manager
Telephone (0116) 305 7656
Email: Colin.Pratt@leics.gov.uk

Chris Tambini, Assistant Director Strategic Finance & Property
Telephone (0116) 305 6199
Email: Chris.Tambini@leics.gov.uk

Infrastructure options

Addressee

This paper is addressed to the Investment Sub-Committee of Leicestershire County Council Pension Fund ("the Fund").

The purpose of this paper is to discuss options for increasing the Fund's exposure to Infrastructure from the current 3% target to the proposed 5% allocation, i.e. an additional £60m (around $87m[1]). In particular, we provide further detail on the scope for co-investment options with KKR and two open-ended fund options that would fit with the Fund's existing arrangements; one from JP Morgan and one from Aviva Investors.

The note has not been prepared for use for any other purpose. It should not be released or otherwise disclosed to any third party except as required by law or regulatory obligation or without our prior written consent.

Background

It has been agreed that the Fund increase its infrastructure target allocation from 3% to 5%. This will bring the strategic allocation to real assets up to 24.5%.

The Fund has three existing infrastructure holdings that currently bring it to just under the current 3% target allocation: IFM Global Infrastructure and KKR Global Infrastructure Fund I and Fund II.

IFM's fund is open-ended therefore further capital could be committed over time. The Fund currently has a $15m 'top-up' investment in the IFM queue, and it is likely to take at least six months to get this invested. There are then other investors in the queue that will be drawn before any future commitment from the Fund could be drawn down, which is likely to mean that a further commitment could take well over a year to be drawn. Of course these timescales are uncertain, dependent as they are on the size and timing of new transactions. IFM do not offer coinvestments to any partner with less than $300m to deploy. Hence, we recommend not to consider IFM as part of the equation for the increase in the allocation to infrastructure.

KKR's funds are closed-ended and have already passed their "final close" and therefore no new capital can be committed. However, KKR offer clients the opportunity to co-invest alongside their fund investments and this could be used to increase exposure to the asset class over time.

KKR Coinvestments

The Fund is invested in two KKR infrastructure funds, KKR I and KKR II. These funds are closed, and while a third fund will be raised in due course this is unlikely to be until next year, which would essentially put the increase in the allocation on hold for at least a year.

We have therefore investigated the possibility of coinvesting. Opportunities are likely to be sporadic, but provide scope to invest in assets to which the Fund is already gaining access via the KKR funds. This is an increasingly common practice for large, sophisticated investors in infrastructure as it gives them more discretion over their portfolio. It also has the advantage that lower fees typically apply to any co-investment.

The assets for which KKR would be seeking coinvestment capital at the present time would typically also be in KKR II. This would result in an increased exposure to those assets. However, if the capital allocated by the Fund to each coinvestment deal was kept small (perhaps $5-10m), then the absolute level of exposure to any individual asset would be proportionate in the context of the overall fund and so retain the benefits of diversification.

1. Most global infrastructure funds raise commitments, and value their assets, in US Dollars. For the purposes of this report we refer to the US Dollar based figures derived using an exchange rate of £1=$1.45. There are differences that will arise when expressing the target allocation as a % of a sterling Fund (currently around £3bn) but potential commitments in $. However, it would take sizeable shifts in either total asset value of the £/$ exchange rate to mean that the intended outcome of achieving a 5% weighting within infrastructure is missed by a significant amount.

By limiting the size of any individual coinvestment by the Fund to $5-10m per transaction this would only provide a partial solution to achieving the additional £60m to be allocated to infrastructure in a timely manner.

We propose that approximately 1/3rd of the additional infrastructure weighting (£20m or $29m) is reserved for potential coinvestments with KKR, implying a target of between 4 and 6 coinvestments. In reality the total value invested in coinvestments can be amended (up or down) to ensure the Fund remains close to its target 5% weighting to infrastructure.

An important aspect of co-investing would be the requirement for the Fund to assess the attractiveness or otherwise of each of KKR's coinvestment opportunities and make a decision on each in a timely fashion. This process would typically involve the following (caveated heavily with the proviso that every process can be slightly different with its own idiosyncratic elements):

- An initial call with KKR to explore the opportunity and register interest
- Agreement of a non-disclosure agreement ("NDA")
- KKR would then release the due diligence ("DD") documentation, which would include various valuation metrics including base case, lower case and upper case forward looking projected returns
- Assessment of the DD documentation, including a call with the KKR deal team
- Make a binding decision and commit the capital.

Importantly, the Fund would need to be able to perform this assessment and make a decision on each coinvestment opportunity in a relatively short time period – anything from 2-3 weeks to 2-3 months (although usually at the upper end of this scale). The ability to make a timely decision is absolutely key – managers really value investors that can do this quickly and efficiently, and prefer to work with those investors that they know to have this capability. Hence, in order to realistically consider coinvesting it would be necessary for the Director of Finance to use his delegated powers, which include consultation with the Chairman and subsequent reporting of the use of these powers to the Local Pensions Committee, to approve individual investments.

JPMorgan

JP Morgan have a well-established, open ended, core infrastructure fund, the JP Morgan Infrastructure Investments Fund ("IIF"). It is similar in structure to IFM's fund, but focused on mid-market deals unlike the IFM fund, which is more focused on the large-cap space (the recent Indiana Toll Road transaction being a good example).

The target return on the fund is 10-12% p.a. net of fees.

IIF is currently open for new commitments and the queue is zero, with full visibility on the underlying 14 investments. The next round of subscriptions would be in June 2016.

Team

The JPM Infrastructure team consists of 60 people, with the investment professionals evenly distributed between New York and London. The team is led by Paul Ryan (CEO) and Matt LeBlanc (CIO). These two are both based in New York and took over the team after something of a personnel clear out in 2013/14, when several senior people, including Mark Weisdorf (CEO), Jason Zibarras (CIO) and Surinder Toor (Head of Asset Management) left. It has taken us some time to get comfortable that the new team is settled and operating well and we now have complete confidence in them. Paul Ryan is an Australian who clearly knows the infrastructure market well, especially in the US, while Matt LeBlanc has a long track record in the sector. They are complemented by a strong team London-based European team led by Andrew Truscott.

Portfolio

The 14 existing investments in the IIF have a net asset value of $5 billion, and all but one is generating positive yield (an improvement from just 5 from 9 assets in 2013, which is an indication of the improvements brought about by the personnel changes in 2013). The overall portfolio has been generating cash yield of around 6% consistently since 2011, which looks set to continue. JPM is the largest or co-largest investor in all but one of the 14 assets.

There is around 55% leverage across the portfolio, though this is biased by the 70% leverage in two utility companies. The rest of the portfolio is about 35% levered.

All redemptions thus far have been financed by dividends so there has been no need for other liquidity measures (we understand that most redemptions have been Solvency II related).

Pipeline

The IIF currently has around $300m of soft commitments, but also has a strong pipeline of attractive opportunities to deploy capital, particularly through "bolt-on" acquisitions to existing platform assets (which tend to be less competitively bid). It now has strong platforms in several industry segments, and the team estimates that 30-50% of new investments will be bolt-ons to existing assets.

In the near-term JP Morgan have visibility into the following pipeline opportunities:

Sector	Location	Equity (mm)
Open Investment Opportunities		
Power Generation - Diversified Renewables	US	USD 650.0
Electric Distribution	US	USD 950.0
Ports	US	USD 375.0
Ports	US	USD 515.0
Power Generation – Wind	Europe	TBD
Platform Investment Opportunities		
Power Generation - Gas	US	USD 34.5
Regulated Water Utility	US	USD 31.6
Power Generation - Gas	US	USD 575.0
Power Generation - Wind	UK	USD 124.8
Regulated Water Utility	US	USD 16.0

At our most recent meeting in February 2016 both Ryan and Truscott were very confident that there are plenty of assets available in the mid-market at reasonable prices. This is true especially in the US energy generation sector, which is much more fragmented than Europe and where (apparently) a "distrust of foreigners" means that JP Morgan can occasionally have an advantage in sourcing deals compared to the Australian and Canadian pension funds and the Middle Eastern and Asian sovereign wealth funds.

Fees and LGPS program

Fees for IIF comprise a tiered management fee scale and a performance incentive fee.

JPM have put together an LGPS Program, which allows the IIF to treat all LGPS fund investments in aggregate for the purpose of the management fee calculation.

The program requires a minimum of $200 million in aggregate commitments from LGPS funds before the reduced fee terms are offered. It currently has $155m in commitments from Cumbria and Lincolnshire, so any meaningful commitment from Leicestershire would take it over the first hurdle.

The LGPS management fee terms are summarised in the table below.

Total assets committed	6 Year lock	9 Year lock
Over $200m	1.125%	0.975%
$300m - $400m	1.05%	0.90%
$400m - $500m	1.02%	0.875%
Over $500m	0.98%	0.85%

Hence, if total commitments to the LGPS program are $400m, the Fund would pay a management fee of 1.02%.

The management fee commences when capital is drawn, is charged on cost until the third anniversary of the drawdown, then on NAV each successive third anniversary thereafter.

In addition, investors will be charged incentive fees of 15% of returns above a net hurdle of 7% per annum, up to a maximum of 13.5% per annum, measured over rolling three year periods.

The 9 year lock would mean the Fund committing to IIF over this period in exchange for a 15bps p.a. fee reduction. To the extent that the Fund is likely to retain its strategic weighting to infrastructure this length of lock-in should not be considered an impediment. However, it would remove the flexibility to reduce the allocation if it were felt that infrastructure assets had become overvalued and agreeing a 9 year lock is effectively a call on the long-term future abilities of the JPMorgan infrastructure team. In this context, we do not consider the size of fee reduction for a 9 year lock to be overly compelling.

Hymans Robertson View

The JPM solution is a good one – it has no queue, a good pipeline of deals, is globally diversified, and has more of a mid-market focus than IFM. Despite the lower LGPS-specific tiered fee structure, the fees are still relatively high.

The overall offering of an open-ended fund with visibility of existing assets, the prospect of the commitment being deployed relatively quickly and a highly capable team makes the opportunity attractive and we suggest a commitment of 2/3rds of the additional infrastructure weighting (i.e. £40m, $58m).

Aviva

Aviva's REaLM Infrastructure Fund has an open-ended structure similar to IFM's but with a very different investment focus. The fund acquires assets in areas such as small-scale solar, medium-scale wind and biomass; namely niche, complex areas of infrastructure where it can build a scalable and repeatable set of skills and expertise and develop a competitive advantage. There are few competitors for assets in these areas – the REaLM team tell us that they typically come up against family offices and small asset managers, and very rarely do they see the same competitor more than once.

The fund is unlevered, which reduces risk (and potentially return due to the removal of gearing) compared to typical infrastructure funds. Since inception in 2012 the Fund has completed 20 transactions valued at a total of £534m and the fund has a cash flow target of 8% p.a. net of fees. However, despite the lack of leverage it has been able to deliver consistent returns of almost 12% net of fees, with 8% of this coming from cash yield.

Much of the return has been delivered by the portfolio's solar assets, which does highlight a potential concern; the supply of UK solar assets has dried up, and the team do not expect many transactions in this area going forward. The focus of the new transactions has now switched to wind power and biomass. While there is no reason to doubt the team's ability to transact in this space there is also no guarantee that they will be able to build the set of scalable and repeatable skills (or returns) in these areas that they have in solar.

Whilst past performance is very good, the fund is very niche in that it is almost entirely focussed on UK alternative energy assets. As a result we do not believe that the fund is appropriate to be part of the Fund's core infrastructure assets, which are deliberately global and multi-sector. However, this fund, or another specialist alternative energy fund, might be an appropriate investment for the Fund's 'Opportunity Pool' and further consideration will be given to this in future.

Prepared by:-

John MacDonald, Senior Research Consultant
Andy Green, Partner

March 2016, for and on behalf of Hymans Robertson LLP

Risk warning
Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, 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 amount originally invested. Past performance is not necessarily a guide to future performance.

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Agenda Item 9

By virtue of paragraph(s) 3, 10 of Part 1 of Schedule 12A
of the Local Government Act 1972.

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By virtue of paragraph(s) 3, 10 of Part 1 of Schedule 12A
of the Local Government Act 1972.

Agenda Item 10

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