HYMANS ROBERTSON LLP

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.

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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.