Leicestershire County Council

# 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.

**<u>Possible future structure of infrastructure investments</u>**

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