Agenda Item 6

INVESTMENT SUBCOMMITTEE – 11TH OCTOBER 2017

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

RECOMMENDED INVESTMENT INTO 'OPPORTUNITY POOL' INVESTMENTS

Purpose of the Report

1. The purpose of this report is to provide information in respect of recommended investments in three different pooled investment funds that are considered appropriate as part of the Fund's 'Opportunity Pool' strategy. The proposed investments concern the M&G Debt Opportunities Fund IV (DOF IV), SL Capital Secondary Opportunities Fund III (SOF III) and Infracapital Greenfield Partners I (IGP I).

Background

2. The Fund has a target allocation of 4 – 6% of total Fund assets to the 'Opportunity Pool' concept. In broad terms these should be considered as investments that are expected to produce returns that are at least as high as those expected from equity markets, but which will provide an element of diversification. They will generally not fit comfortably elsewhere within the Fund's overall asset allocation strategy, either due to their higher risk/higher return nature or because the opportunity is in a very niche area, and will often be investments that take advantage of market opportunities that exist at a point-in-time but that appear unlikely to persist indefinitely.

3. At present only £85m of the available Opportunities Pool funding is invested, equating to 2.1% of total Fund assets, and this is all within specific opportunities within debt markets (via three M & G Debt Opportunities Funds). A further c.£75m has been committed to Opportunity Pool investments but is currently 'undrawn' (a small undrawn commitment for M & G Debt Opportunities Fund III, c.£30m committed to Markham Rae Trade Capital Partners and a recent £40m commitment to CRC Capital Release Fund III). The DOF III and CRC commitments are likely to be drawn before the end of the calendar year, whilst the Markham Rae fund has been disappointingly slow to secure any investments and is expected to take another 12 months to deploy its capital fully. This will take the Opportunity Pool up to about 4% of total assets of the Fund, which is the lower end of its target range.

4. There is no reason to make Opportunity Pool investments unless they are considered likely to offer better risk-adjusted returns than where the money would otherwise be invested. If all three of the recommended investments are approved by the Investment Subcommittee the amount of capital committed to the Opportunity Pool will be close to the 6% upper limit, but it is worth noting that the new capital will be drawn over a period of up to three years. Within this period there is likely to be meaningful returns of capital from the existing Opportunity Pool

investments (most notably DOF I and DOF II), so there will still be scope to make further Opportunity Pool investments if appropriate ones become available.

5. Investment pooling within the LGPS is due to commence on 1st April 2018 and it is highly likely that the concept of opportunistic investment will remain available to the Funds that will be part of LGPS Central, although the majority of them currently do not utilise it. It is unlikely, however, that individual Funds will have the ability to choose which opportunities they wish to invest in; instead the control over opportunistic investments will be in the amount of capital available from each Fund. The fact that three Opportunity Pool investments have been brought to this Subcommittee at the same time is nothing more than coincidence, and is in no way linked to the imminent introduction of investment pooling. Given that the Local Pension Committee will retain responsibility for asset allocation going forward, it is entirely within its control to continue to increase the Fund's weighting in Opportunity Pool investments if it is felt that attractive opportunities continue to be available.

Proposed investment opportunities

M&G Debt Opportunities Fund IV (DOF IV)

6. The Fund has invested in the previous three iterations of DOF, and the investment process remains unchanged from that which has previously proven successful. DOF I has so far returned £46m on a £35m investment and there is a residual value of over £5m; it is almost certain to produce a return that is very close to its target of a 15% annual return. Of the Fund's £40m investment in DOF II, cash distributions of £15.3m have been received and £36m of value remains. Most of this value should be realised within the next 2 years and the conservative valuation approach to the investments held gives a reasonable prospect of the return reaching the target level from its current 10% p.a. DOF III is currently 85% 'drawn' and should be fully drawn before the end of 2017; current investment returns are very encouraging (and above the target level) but it is too early to form a definitive judgement on the success of the fund.

7. There will be significant returns of capital from DOF I and (in particular) DOF II over the next two years, and it is likely that DOF III will start to distribute capital towards the end of this period. In order to maintain the current weighting to the strategy it is estimated that a commitment of £40m would be required to DOF IV, should the Subcommittee wish to continue with its approach. Because this commitment will be 'drawn down' over a period of two years, it will simply re-invest the capital that is expected to be distributed by the previous DOF funds.

8. A detailed report by Hymans Robertson, the Fund's Investment Consultant, on this investment opportunity, which includes exempt information, is included later in today's agenda. A brief overview of the opportunity and why it is considered attractive is given below:

- Same investment process that has worked on previous DOF funds
- Key personnel remain in place, with enhanced resource
- Opportunity still exists and can be accessed by relatively few managers due to the skills required; competition has not reduced prospective returns
- As an investor in most corporate bond issues, M&G have significant knowledge of the underlying financial position of bond issuers
- Team deals with all credit restructurings on behalf of M&G, but is able to ‘cherry pick’ the really attractive opportunities for DOF
- Proven record of active involvement, often as the biggest investor, of balance sheet restructurings that are bond-holder ‘friendly’

Infracapital Greenfield Partners I (IGP I)

9. Infracapital is the specialist infrastructure arm of the Prudential, of which M&G are also part. They have significant experience of investment in the asset class although this is the first fund that they have launched that is dedicated specifically to infrastructure investment at a relatively early (‘greenfield’) stage. Most infrastructure investors are focused on operational assets (‘brownfield’) as the risks are lower, there is greater visibility over revenues and the opportunity to sell assets is more obvious.

10. The Fund has a specific asset allocation to infrastructure of 5% and this is invested via KKR, IFM and JPMorgan. Whilst there are some instances of greenfield investment within these portfolios, they are heavily weighted towards brownfield opportunities. The popularity of infrastructure as an investment has increased significantly in recent years, with brownfield being the favoured approach of most investors. This has led to increased competition for operational assets and deals that are hotly contested; inevitably this competition leads to lower future returns due to higher entry prices.

11. Infrastructure managers are having to be much more nimble to achieve attractively-priced purchases, and the Fund’s existing infrastructure managers have exhibited clear evidence of their ability to continue to buy at reasonable prices (and to sell at levels that they feel discount future prospects for the assets). There remain relatively few infrastructure managers that have the skills to actively pursue greenfield opportunities, and many of their investors would generally not be comfortable if these opportunities made up a particularly meaningful proportion of their portfolio. A specialist greenfield fund offers the prospects of much higher returns than are available from brownfield investments, but there are obviously higher risks involved. Infracapital are one of few managers that has the resource and experience to suggest that they can exploit the investment opportunity.

12. A detailed report by Hymans Robertson, the Fund’s Investment Consultant, on this investment opportunity, which includes exempt information, is included later in today’s agenda. A brief overview of the opportunity and why it is considered attractive is given below:

- Lack of competition for greenfield infrastructure projects, due to higher risk and required level of expertise. Many of the risks can, in part, be mitigated.
- Experienced and well-resourced team with experience of previous greenfield investments.
- Requirement to tie up capital for a significant period, even if liquidity opportunity is taken after 8 -10 years
- Discounted fees for Local Authority investors
- Considerable investment by Prudential, which gives close alignment of interests between investment manager and external investors
- A number of existing deals reduces ‘blind pool’ risk and means significant capital should be drawn relatively quickly
- Final close of fund is imminent, so no prolonged period of fundraising

13. It could be argued that IGP I should simply be included as part of the Fund’s infrastructure weighting, but its risk/return profile fits much better within the Opportunity Pool. Ultimately it has to be expected that infrastructure investors will become more comfortable with the risks associated with greenfield opportunities, that managers will increase their resource in this area and that the level of return currently available will be reduced in the future by the increased availability of capital. The expectation of a finite period of the availability of an enhanced return fits in well with the Opportunity Pool concept. It is also worth noting that the greenfield assets being purchased by Infracapital will evolve into brownfield assets, so in the future it may make sense to reclassify this as a lower risk infrastructure investment, thereby freeing-up capital for the Opportunity Pool. This point is, however, at least five years away.

14. Given the higher risk/higher return nature of IGP I, a £30m (0.75% of total Fund assets) is recommended. This is sufficiently high that the investment will have an impact onto total Fund returns, but not sufficiently large that a poor outcome will be disastrous to either the Fund or the Opportunity Pool (if the Opportunity Pool were judged on a stand-alone basis).

SL Capital Secondary Opportunities Fund III (SOF III)

15. SL Capital (SLC), the manager of SOF III, is a wholly-owned subsidiary of Standard Life Aberdeen, which was recently formed by the merger of Standard Life and Aberdeen Asset Management. The team that will be responsible for managing the Fund is the one that dealt with predecessor private equity funds at Standard Life so the merger has not had an impact from an operational perspective. Aberdeen had its own private equity team and it is possible that this will ultimately be integrated, but this is considered likely to be a positive as it will provide more resource.

16. Private equity can broadly be described as investment in the shares of any company that is not listed on a public stock exchange. It covers a huge range of opportunities – from small start-up businesses to significant listed companies whose ownership is being taken private – but there will always be an expectation that an investment will produce a higher return that listed equites. The higher risk is accepted only due to the expectation of a higher return.

17. There are a number of ways in which investors can gain access to private equity, but most will do so by investing in pooled funds that are managed by specialist managers. These pooled funds are usually structured as Limited Partnerships and

could be considered to be the equivalent of a unit trust – the Limited Partnership makes investments into individual companies, with the investor effectively owning a pro-rata share of the underlying companies via its holding in the Limited Partnership.

18. Private equity Limited Partnerships produce an unusually large range of investment returns – the better performing ones do exceptionally well, and the poorer performing ones can be extremely disappointing. As a result most investors will build a portfolio of Limited Partnerships to spread the multiple risks that exist within the asset class.

19. The Leicestershire Fund does not have the expertise or relationships to be able to access the more highly-regarded private equity Limited Partnerships that are launched; the better managers tend to be able to fund their capital raising from investors in their previous funds and will not accept commitments from new investors. As a result the Fund's significant exposure to private equity (4% of total assets) is managed by Adams Street Partners in what is predominantly a 'Fund-of-Funds' arrangement.

20. With this arrangement the Fund invests in an Adams Street Partners pooled fund, and it is the Adams Street Partners pooled fund that invests into Limited Partnerships. Whilst this involves an additional layer of fees, it provides a level of expertise and access to the better performing private equity funds that would otherwise not be possible. The arrangement with Adams Street Partners has been very successful.

21. Within private equity Limited Partnerships there is no 'natural' liquidity, and investors commit to invest for the whole period of the Partnership (usually a minimum of 10 years with the possibility of further extensions to maximise value). Investments (drawdowns) are made when the manager requires cash to pay for the purchase of the underlying companies and sale proceeds (distributions) are paid back to investors when the underlying investments are sold.

22. Whilst the vast majority of private equity investors accept this lack of natural liquidity, there are some that are interested in selling parts of their portfolio for a variety of reasons and an active 'secondary market' exists (i.e. the willingness of other investors to purchase existing holdings at an agreed price that is linked to current net asset value of the Limited Partnership).

23. Secondary market purchases can be keenly contested. There is visibility through to the underlying investments and how well they are performing, they are often in the distribution stage so the returns are achieved quite quickly and discounts to net asset value are often available. Most secondary market purchasers, however, only like investments that are 'clean' and where it is easy to assess 'value'; typically funds run by highly respected private equity managers with mature underlying companies.

24. SOF III could be broadly categorised as a fund that is looking to purchase secondary private equity interests in areas where they can utilise their experience and position to identify opportunities that are misunderstood by other secondary investors or, frankly, considered too difficult to pursue. This may involve buying positions in fund-of-funds (which would normally be avoided by secondary

investors), taking positions in relatively small Limited Partnerships or becoming involved in situations that are more complex to resolve. The lack of competition within these areas will be key to producing the high returns that are targeted.

25. SOF II currently has a relatively sizeable amount of capital that is not committed, but the pipeline of deals is such that SLC feel that the time is appropriate to raise a successor fund. Within SOF II the manager has shown a willingness to wait for the right investment opportunities, rather than feeling compelled to invest the available capital quickly. This is ultimately positive for investors as it should provide a better investment outcome.

26. A detailed report by Hymans Robertson, the Fund's Investment Consultant, on this investment opportunity, which includes exempt information, is included later in today's agenda. A brief overview of the opportunity and why it is considered attractive is given below:

    - Private equity is likely to continue to see sellers into the secondary market, and a limited number of purchasers that are willing to consider more complex opportunities
    - Experienced and well-resourced team with a track record of managing previous funds with similar objectives
    - Capital deployed over a three year period into a diverse range of opportunities, most of which will already be relatively mature by private equity standards
    - Discounted fees for Local Authority investors. Fees only charged on drawn capital
    - Entry and exit points will be phased over a number of years, so not overly exposed to economic cycle
    - Final close of fund is imminent, so no prolonged period of fundraising

27. This investment could be considered part of the Fund's private equity strategy, although the high level of targeted return (which is partly a function of forced sellers and few interested buyers for more difficult holdings) fits exceptionally well into the Opportunity Pool concept. It is expected that as more standard secondary opportunities become increasingly competitive – there is a significant weight of capital looking for 'simple' secondary purchases, which will force down future returns from them – managers will seek to access more complex areas of the market, particularly if returns from these transactions remain high.

28. An investment of £30m is recommended for SOF III, which seems appropriate given the higher risk/higher reward nature of the opportunity.

Summary

29. Taking into account the committed (but not yet drawn) capital within the Opportunity Pool, the Fund's weighting will rise to around 4% over the next 12 months. This is at the lower end of the target range of 4% - 6%, and the search for appropriate opportunities has taken a considerable length of time. The three opportunities are all in different niche markets that rely almost entirely on the skill of the manager to generate returns. Individually they could be considered to be towards the higher end of risk and return that is acceptable to the Fund, but they are all significantly differentiated from each other.

30. Investment in DOF IV should simply be seen as the reinvestment of the capital that will be repaid from the previous DOF funds. The timing of distributions and drawdowns will not be perfectly aligned, but a £40m investment will not increase the total amount invested within the DOF strategies for any length of time.

31. If approved, £30m investments into each of Infracapital and SOF III will increase the committed capital within the Opportunity Pool to around 5.5%. As a result there is still scope to add at least one further Opportunity Pool investment without any consideration of increasing the upper limit of the range. However in reality future capital drawdowns will take place over a prolonged period of time and this will give the Fund extra flexibility to consider further investments.

Supplementary Information Informing the potential investment

Exempt papers by Hymans Robertson and presentations from investment managers representing M&G Debt Opportunities Fund IV, Infracapital Greenfield Partners I Fund and SL Capital Secondary Opportunities Fund III, which are of a sensitive nature, are included as items 9, 10, 11 and 12 on the agenda.

Recommendations

32. The Investment Subcommittee is recommended to approve:

(i) A £40m commitment to invest in the M&G Debt Opportunities Fund IV;
(ii) A £30m commitment to invest in the Infracapital Greenfield Partners I Fund;
(iii) A £30m commitment to invest in SL Capital Secondary Opportunities Fund III.

Equality and Human Rights Implications

None specific

Officers to Contact

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

Chris Tambini, Director of Finance
Telephone (0116) 305 6199
Email: Chris.Tambini@leics.gov.uk

This page is intentionally left blank