



INVESTMENT SUB COMMITTEE – 28TH JULY 2021

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

RECOMMENDED INVESTMENT: LGPS CENTRAL INFRASTRUCTURE FUND

Purpose of the Report

1. The purpose of this report is to provide information in respect of a recommended investment into the LGPS Central (Central) Infrastructure fund.

Background

2. Institutional infrastructure investing is usually conducted via private markets where units or shares in a fund are not traded on a liquid market. Investing covers a broad spectrum of risk and return.
3. Open ended and closed ended fund structures are available with each having differing characteristics. The Leicestershire County Council Pension Fund (“the Fund”) has both open and closed ended investments within the portfolio of holdings. The JP Morgan and IFM holdings being open ended investments where there is some visibility of portfolio holdings when investing and some liquidity exists via queued investment and redemption. The Fund also has some closed ended funds such as KKR and Timberland where investments are usually allowed during the fundraising stage and liquidity is limited to secondary sales or awaiting the natural maturity of the fund which can be from five to twenty-five years.
4. The Fund has a target allocation of 9.75% of total Fund assets to the infrastructure asset class. This allocation was approved at the January 2021 Local Pension Committee meeting. As at 31st March 2021 the actual allocation was 7.4%, implying an underweight position of 2.35% or c£120m.
5. The Fund has made a recent commitment (£20m GBP) in October 2020 to the JPM IIF fund whilst the Central offer was being progressed and the Fund was underweight. This commitment joined the queue of commitments to be called and should be called later this year.
6. At present the Fund has infrastructure exposure via five external investment managers totalling £382m at 31st March 2021.
 - a. Stafford Timberland - £135m – closed ended
 - b. IFM - £107m – open ended
 - c. JP Morgan - £84m – open ended
 - d. KKR - £38m – closed ended
 - e. Infracapital - £18m – closed ended

7. As at 31st March 2021 the fund had a cash holding of c£170m with a combination of GBP and USD. In addition, the Fund also held collateral with Aegon of £119m for the currency hedging programme.
8. Officers have engaged with Hymans Robertson to provide assurance which covers the following criteria for both the Central infrastructure product.
- Structure, governance & senior leadership of the pool manager
 - Investment team
 - Philosophy & Process
 - Product design & investment strategy
 - Responsible Investment integration
 - Fund structure
 - Fees & additional costs
 - Performance & risk

Proposed investment LGPS Central Infrastructure

9. Central have created an open-ended product with two sleeves, one targeting the lower end of returns and one a higher return, these are called core / core + and value add / opportunistic.
10. The decision to defer a commitment to the value add / opportunistic sleeve is based on the following:
- a. Commitments to the sleeve need to be in excess of £150m in order to achieve fee savings
 - b. A more realistic target return agreed (at present is CPI + 5%)
 - c. Further details of the investment pipeline and likely composition of the initial portfolio are available, including reassurance that the expected fee savings are indeed larger than the Fund could have achieved independently.
11. The Hymans proposal is to consider the lower returning core / core + sleeve for investment at the present time.
12. A summary of the mandate for the core / core+ sleeve is shown below.

The Core/Core+ sleeve will aim to:	After the fourth anniversary of the sleeve's closing date, the Core/Core+ sleeve will not:
<ul style="list-style-type: none"> • Invest in core infrastructure within the range of 35%-65%. • Invest in core-plus infrastructure within the range of 35%-65%. • Hedge foreign currency exposures relating to cash calls or distributions at their discretion. • Limit exposure to infrastructure funds whose investment strategy is exclusively to invest in residential assets to 5% of commitments. • Limit exposure to infrastructure funds whose investment strategy is exclusively to invest in debt 	<ul style="list-style-type: none"> • Invest more than 25% of commitments to funds managed by a single investment manager. • Invest more than the following to a single infrastructure fund: 20% if total commitments to the sleeve are less than £500 million, 15% if total commitments are greater than £500 million but less than £1 billion, and 10% if total commitments are greater than £1 billion. • Invest more than 50% of commitments in non-sterling denominated underlying infrastructure funds. • Invest more than 10% of commitments in underlying investments not domiciled in the OECD.

<p>investments to 3% of commitments.</p> <ul style="list-style-type: none"> • Diversify across at least three of the following sectors after the fourth anniversary of the first close: energy; utilities; transport; social; telecommunications; and other. • Minimise cash holdings for the primary purpose of distributions to Partner Funds and other capital requirements of the Master Partnership. 	<ul style="list-style-type: none"> • Invest more than 5% of commitments in listed infrastructure funds. • Arrange or permit fund-level leverage. • Invest in co-investments without the prior approval of the LPAC. (advisory committee)
---	---

Fund structure

13. Hymans are comfortable with the structure of the infrastructure sub fund which is a sub fund of the Central alternatives pooling partnership (the Master Partnership). The sub fund is GBP denominated and is comprised of the two sleeves described earlier.
14. Commitments can be made on a quarterly basis and are subject to a lock in from the initial commitment date for four years for core / core + and five years for the value add / opportunistic sleeve. Commitments would not be called by Central until required. Redemptions after the lock in period are via two redemption windows per year.
15. Commitments are called in tranches that partner funds invested in. For example, if a Fund commits in Q1 then when a call is made to an underlying investment those Funds who had committed first get called based on their percentage of that tranche. At present two partner funds have made commitments to the core / core + sleeve and as such if the Fund were to commit to the core / core + sleeve the Fund's commitment would be added to the remaining commitments from the previous two and be drawn pro rata.
16. Any commitments made will be shared amongst all investors in the relevant sleeves on a pro rata basis irrespective of when they commit to the sleeve owing to the open-ended nature of both sleeves.
17. Given that underlying funds may be closed ended and the sub fund is an open ended structure, redemption rights are limited and complex to protect the sub fund and the interests of the partner funds. Distribution from income and return of capital will be made to partner funds on a quarterly basis.
18. Once the lock in periods has expired and partners funds wish to redeem, Central would:
 - a) Cancel any outstanding uncalled commitment from the redeeming investor
 - b) Draw down other partner funds uncalled commitments to acquire units in the Fund, with proceeds of this providing redemption monies for the exiting investors
 - c) See if other Partner Funds wish to make additional commitments to the Fund
 - d) Redeem units in underlying open-ended Funds
 - e) Use revenue and capital distributions from underlying investments
 - f) Sell underlying closed ended funds in the secondary market. Where any loss in value versus holding cost is borne by the exiting investor.

19. In addition, the officers of the various partner funds meet once a month where a standing agenda item will be commitments and redemption into Central products.
20. Hymans are comfortable with the structure but note the liquidity risk in their assurance paper and advise Central be engaged at the earliest opportunity to advance any redemption requests. They further note that Central's valuation policy be monitored given the inherent subjectivity of pricing assets in an illiquid market so as to protect investors. For example, if a new investor invests into a sleeve when asset values may be understated. Hymans have reviewed Central valuation policy and believe it is appropriate.

The Team and Central's structure

21. Hymans note that Central have a comprehensive set of operational policies in place and an independent compliance and risk team. Overall, they are comfortable with LGPS Central's structure, with the firm appropriately regulated to carry out investment activity on behalf of its Partner Funds.
22. They are also comfortable with the level of experience within the leadership team but recommend the stability of the leadership and wider investment teams be closely monitored. Furthermore they have no concerns over ongoing governance at the firm.
23. They also have reviewed the team responsible for managing the infrastructure mandate and note they believe the team to be of adequate size and experience to successfully manage the strategy. They note that the team is small and lacks the depth of infrastructure investing experience typically seen at fund of fund managers but they compare favourably to some infrastructure teams within other LGPS pools.
24. Central's team is lead by an investment director with 23 years investment experience with 10 years infrastructure experience, he is supported by a senior portfolio manager with 13 years' experience across infrastructure, property, M&A and corporate finance. They are also supported by a portfolio manager and two investment analysts. Central aim to add more junior resource which is to be shared amongst the private markets team that infrastructure sits within.
25. Hymans note that the team will be responsible for a number of mandates eventually (direct & indirect property for example) and as such they would be more comfortable with more resource to be added to the team, particularly at more senior level.

Philosophy, process and potential managers

26. Hymans reviewed the nine stage investment process, starting with the design of the mandate and ending with oversight and monitoring of the fund. They are comfortable with the manager's investment philosophy (including the two funds outlined below) and we believe that they have a robust manager selection and monitoring process in place with Responsible Investment given meaningful consideration throughout the process.
27. Hymans have reviewed the one commitment made to the value add / opportunistic sleeve (Copenhagen IV Fund) and the approved commitment to the KKR diversified core infrastructure (DCI) fund for the core / core + sleeve.

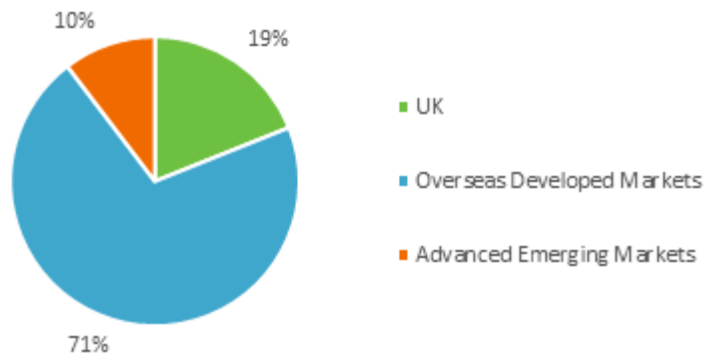
KKR DCI fund

28. This is an open ended core infrastructure fund that will look to make long-term investments in developed countries (North America, Western Europe and Asia). The fund has a target IRR of 8-10% gross (7-9% net), with a target cash yield of 4-6% p.a. This is KKR's first core-focused infrastructure fund having focused historically on value-add infrastructure and represents another large infrastructure investor launching a lower risk product to complement their existing value add fund range. The Leicestershire Fund has had previous exposure to the value add KKR funds having invested in a number of their prior closed ended offers.
29. KKR's approach to core is to focus on long-duration, mature assets that are critical to the functioning of economies. There is a strong focus on assets that deliver highly predictable cash flows, with the majority of returns driven by income. Hymans note that in their meetings with KKR they are comfortable that they have sufficient core infrastructure expertise within the firm and note that they have managed core infrastructure mandates for investors for a number of years.
30. Hymans note that the net return of the KKR fund (7-9%) is higher than the target return of the LGPS Central core/core-plus sleeve (CPI+3.5%). However, they note that the KKR fund's target is well within the range they would expect for core/core + funds generally. Further, based on discussions with LGPS Central, they would expect them to use the outperformance of the KKR fund to provide "headroom" above their own target, rather than focusing the remaining investments on very low yielding strategies. Hymans note they are comfortable with this.
31. Officers have been in discussion with Central regarding measurement of performance of the sleeve to reflect the targets of the underlying funds as well as the target for the sleeve set at the outset

Product design and investment strategy

32. As at 31st March 2021 the Fund held £382m in infrastructure funds between 5 managers as described within the background section of this paper. These investments form part the Funds 'income' allocation.
33. Hymans have looked at the Fund's existing holdings and potential new holdings based on the Central mandates (core / core + and value add / opportunistic) to conclude the following:
- a. The Fund's combined infrastructure portfolio of investments, the existing five managers plus Central's offering via the two sleeves will be sufficiently well diversified
 - b. Hymans believe that diversification of the Central sleeves will be limited by the requirement to invest 50% of commitments into sterling denominated funds. The inference is that by investing in sterling denominated funds the weighting of UK infrastructure projects would be higher than in a non-constrained setup. Hymans conclude that they consider a 10% - 33% allocation to UK infrastructure to be reasonable and provide the following chart to illustrate what a £90m investment (when fully invested) would mean for the Fund in terms of geographical allocation. UK is allocation is shown at

19%. This assumes the commitment to Central's sub funds is 50% invested in UK assets.



- c. Hymans further note that whilst both funds will invest at least 50% in underlying funds denominated in sterling they do not expect this to constraint to materially limit the opportunity set of investments available to invest in. They further note that the UK benefits from a favourable political and regulatory framework and a deep secondary market for infrastructure assets.
- d. Hymans note that the Fund may wish to consider future investments outside of the pool on non UK portfolios. This would be to satisfy the Hymans view that the UK allocation should be 10%-33%. At present the Fund has a number of options given the gap to the UK maximum allocation and could use existing managers to drive down the UK allocation. Both JPM IIF (open ended fund, core / core+) and IFM global (open ended, value add / opportunistic) provide sub 15% exposure currently to UK infrastructure so could be used in the future to rebalance the UK weighting and both are currently rated as 'preferred' for infrastructure investments.
- e. Other options to rebalance an increasing weighting as considered by Hymans include, redeeming partial investments in the Central funds or collectively challenge Central on the allocation to UK assets with a view to amending the mandate.

Conclusion

- 34. Hymans are overall supportive of an allocation to the LGPS Central Infrastructure core / core + sub-fund. This view reflects their confidence in the process followed by LGPS Central to select appropriate asset managers, to provide ongoing monitoring and the ability to appropriately structure fund products. It also reflects the significant potential benefits of investing via the pool which include lower investment expenses, wider diversification of manager risk and stronger oversight of underlying fund managers than the Fund could achieve acting independently.
- 35. Hymans have listed a number of conditions before a commitment can be made which are explained within the private session of today's agenda.

Supplementary Information

36. Exempt papers which are of a sensitive nature is included elsewhere on the agenda which contains supplementary information on the potential investment in the LGPS Central infrastructure Fund.

Recommendation

37. The Investment Subcommittee is recommended to consider an investment into the LGPS Central infrastructure fund.

Equality and Human Rights Implications

38. None

Appendices

None

Background Papers

39. None

Officers to Contact

Mr C Tambini, Director of Corporate Resources
Tel:0116 305 6199 Email: Chris.Tambini@leics.gov.uk

Mr D Keegan, Assistant Director Strategic Finance and Property
Tel:0116 305 7668 Email: Declan.Keegan@leics.gov.uk

Mr B Kachra, Senior Finance Analyst - Investments
Tel: 0116 305 1449 Email: Bhulesh.Kachra@leics.gov.uk

This page is intentionally left blank