Leicestershire County Council

CABINET - 19 NOVEMBER 2021

RECOMMENDED INVESTMENT INTO PARTNERS GROUP PRIVATE DEBT FUND AND JP MORGAN INFRASTRUCTURE INVESTMENT FUND

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

PART A

Purpose of the Report

1. The purpose of this report is to advise the Cabinet of proposed investment by the Council's Corporate Asset Investment Fund (CAIF) into the Partners Group multi asset credit 6 (MAC 6) private debt, and the JP Morgan Infrastructure investment fund (IIF), and seek members' approval for the investments.

Recommendations

2. It is recommended that a total of £27.5m be allocated from the Corporate Asset Investment Fund for investment in:

   a. Partners Group Multi Asset Credit 6 (MAC 6) private debt - £20m
   b. the JP Morgan Infrastructure Investment Fund - £7.5m.

Reasons for Recommendation

3. The proposed investments are in accordance with the Corporate Asset Investment Fund Strategy 2021-25 which was updated in February 2021 to take account of recommendations made by Hymans Robertson to maintain or increase the weighting to the private debt asset class and to initiate an allocation to core or core plus infrastructure; the types of infrastructure strategy which carry the lowest levels of risk.

Timetable for Decisions (including Scrutiny)

4. The (member) Corporate Asset Investment Fund Advisory Board (CAIFAB) received a report on the proposals on 2nd November 2021 and recommended that the proposed investments be supported, pending the views of the Scrutiny Commission and the Cabinet.

5. This Cabinet report will be circulated to the Scrutiny Commission for consideration at its meeting on 17th November and the views of the Scrutiny Commission will be reported to the Cabinet.

Policy Framework and Previous Decisions

6. In 2017 the Cabinet approved a change to the treasury management policy to allow private debt funds to be added to the list of acceptable investment types with a maximum cash investment of £40m.

7. The creation of the CAIF was included in the Medium Term Financial Strategy (MTFS) 2014/15-2017/18, approved by the Council in February 2014. This has been renewed annually and appropriate provision made within the MTFS to enable the fund to grow.

8. In May 2014 the Cabinet established the Corporate Asset Investment Fund Advisory Board, comprising five Cabinet members.

9. The CAIF Strategy sets out the Council's proposed approach to future asset investments utilising the CAIF. It has been revised since the Fund's creation, including a new section to reflect the Council's environmental commitments and the objectives set out in the Environment Strategy 2018 to 2030 and in response to an independent review of the CAIF which was undertaken by Hymans Robertson in December 2020 which was the subject of a report to the Cabinet on 5th February 2021.

10. On 5th February 2021 the Cabinet approved the Corporate Asset Investment Fund Strategy 2021-2025 for submission to full Council as part of the Medium Term Financial Strategy 2021/22 to 2024/25.

11. The MTFS for 2021-25, approved by the County Council in February 2021, sets out the need for savings of £79m to be made by the Council by 2024/25, of which £23m is as yet unidentified. The position for the new MTFS 2022-26 will be updated and reported to the Cabinet in December 2021.

Resource Implications

12. The current value of the total CAIF at 31st March 2021 was reported as £187m. The proposed spend of £20m into private debt represents circa 11% of the year end valuation. The proposed investment to the JP Morgan infrastructure fund of £7.5m is circa 4% of the year end valuation.

13. The expected returns from the private debt investment is expected to be cash plus 4% - 6%. The JP Morgan investment has a target return of 8%.

14. Management of both investments will be via existing resources. Both investments are included within the Leicestershire County Council Pension Fund and so will be reviewed on a standard timetable.

15. In common with many financial investments there are a range of financial risks which include, foreign exchange risk, market competition, underlying companies or sectors suffering from regulatory, tax, political and climate change to name a few. The proposals to invest are acceptable for level of

return expected. The proposals form part of a diversified portfolio and any underperformance would not be overly detrimental to the CAIF as a whole. Both proposals target the lower end of the risk spectrum focusing on regular income rather than capital appreciation.

16. However, the rationale to invest in these two asset classes reduces the overall risk to the CAIF by diversifying away from directly owned UK property. Also, as longer term owners, the Fund can hold investments through shorter term downturns and volatility.

17. The private debt investment is a treasury management investment which is within the maximum threshold set by the current Treasury Management Strategy.

18. The infrastructure investment will be classified as a capital purchase and can be accommodated within the capital programme through the sale of one or more existing pooled property fund. The timing of the asset sales and purchase cannot be synchronised, but any resulting overlap can be funded from the money set aside for future CAIF investments, as borrowing is not being utilised.

19. The Director of Law and Governance has been consulted on this report and no issues have been raised.

Circulation under the Local Issues Alert Procedure

20. None.

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PART B

Background

Private Debt

21. Private Debt is the name given to an asset class where money is loaned to companies that have not originated from a bank. Companies choose to raise capital from this source for a number of reasons including the cost of the loan, availability of traditional banking credit and the ability to negotiate terms specific to a deal.

22. The loan (or debt/credit) that the investment manager extends to the company is usually senior and secured. Senior debt is repaid before other forms of debt and equity if a company goes out of business. Secured debt is backed by an asset, such as buildings or equipment, that may be sold to cover the debt if the loan goes into default.

23. Private debt investment products may include subordinated debt (debt less secure than senior debt), preferred equity (equity which ranks higher than ordinary equity but lower than debt) and equity, albeit there will be a limit on the riskiest types of lending as defined in the investment mandate. The companies who take on the debt agree in advance the terms of the loan including the interest rate, (fixed or floating) the term of the loan, and if any security is provided in the event of a defined default by the company.

24. Private Debt is an illiquid product; it takes time for money to be invested and selling an investment is often not possible due to limited markets to trade in. As such proposals need to be carefully considered.

25. The Leicestershire County Council Pension Scheme has invested within this asset class for many years, originally via Partners Group products and recently via LGPS Central (the investment management company that the pension fund is a part-owner of).

26. The CAIF has previously invested into an earlier iteration of the Partners Group Multi Asset Credit (MAC) offering, with a £20m investment made to the Partners Groups 2017 MAC fund. As at the end of September 2021 the net asset value of that original investment is around £13.2m with circa £9.6m having been returned via capital and income distributions. The investment has performed in line with expectations.

Infrastructure

27. This is a wide and diverse asset class that invests in infrastructure projects where target returns are estimated at the outset in many cases due to the contractual nature of the projects they can deliver. Infrastructure funds come in many forms and risk profiles. Funds focusing on capital growth tend to be higher risk, with income-focused funds offering more stability for a lower return. Infrastructure funds tend to be illiquid, although increasingly the use of

open ended funds, that do not have a finite life, offer greater liquidity via queued commitment (where popular funds can have a 12 to 18 month timeframe before calling capital from investors) and redemption (where managers can delay return of capital in order to manage the underlying assets of the fund in the interests of other investors). Open ended funds also allow some degree of visibility regarding the types of investment, yields and historical returns.

28. Types of investment for example may include, energy infrastructure, including renewables, water treatment works and transport infrastructure such as rail and air terminals.

29. At present the Pension Fund has infrastructure exposure via five external investment managers totalling £380m.

<u>Hymans Review</u>

30. Officers engaged Hymans Robertson, the investment advisor for the Leicestershire County Council LGPS, in 2020, to review the CAIF Strategy. Hymans produced a report which advised a number of changes, considered by the Scrutiny Commission in January 2021 and the Cabinet in February 2021. Those relevant here are -

    i. to maintain or increase the weighting to the private debt asset class,
    ii. to initiate an allocation to core or core plus infrastructure (types of infrastructure strategy which carry the lowest levels of risk).

31. Key features of core and core plus strategies are outlined in the table below.

Core features	**Core plus features**
Investments into essential assets.	Can involve undeveloped markets with little construction risk.
No operational risk, assets that are fully operational.	Can include assets that require investment but are operating.
Usually located in developed countries.	Assets may have some sensitivity to the economic cycle but can be mitigated with longer term contracts.
Transparent regulatory and political environments.	Can include assets that government or regulatory price support.
Assets display stable cashflows little variability.	

32. These allocations can be made from the existing authorised CAIF budget and would not require divestment of existing assets.

33. The guidance from Hymans included a reduction in pooled property. The CAIF holds three UK commercial property funds. The divestment from one or more of the three holdings will be proposed during 2022 in line with the Hymans guidance.

34. In the short term the private debt allocation will be above the original £20m committed to Private Debt due to the gradual nature of capital calls and distribution. This is not a problem bearing in mind the ‘maintain or increase’ guidance received from Hymans. In addition, the Treasury Management Strategy allows for up to £40m to be invested in private debt investments, the combined value will be below this threshold. The CAIF is currently below the £260m commitment which allows for investments such as this that return money back to the investor. Return of capital is currently expected to be around 2025-2027.

35. New investment in the infrastructure asset class is focused on the lower risk part of the infrastructure spectrum, named core and core plus. The main reason for this addition was to add further diversification and a reasonably high income yield.

Proposed Investment - Partners MAC 6

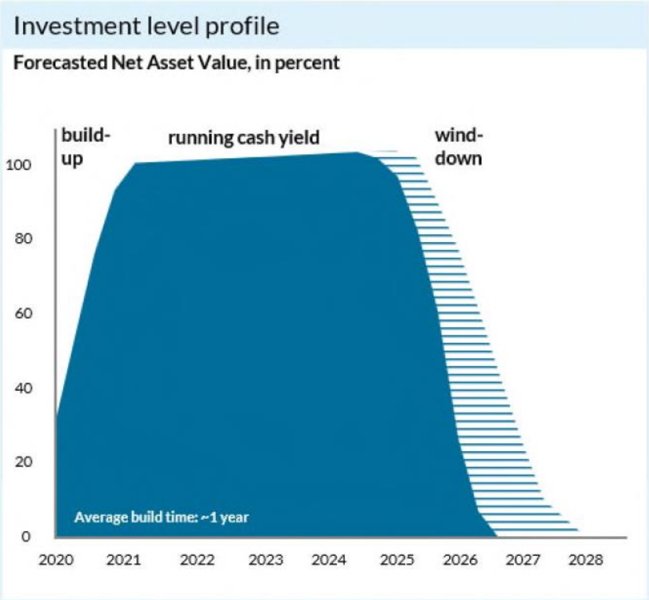
36. Officers propose a £20m commitment to the latest Partners MAC vintage. The current valuation for private debt held by the CAIF is £13.2m with the current fund returning money to the Council. Without reinvestment the remaining value is due to be returned by September 2023. This is in line with the Hymans’ guidance and means the CAIF will not need to recommit to this asset class for three to four years.

37. The performance of this investment will be monitored through the quarterly treasury management strategy reports to the corporate governance committee and will be included within the CAIF annual report.

38. Hymans have recently advised the Pension Fund regarding an investment into the MAC 6 investment and this advice has been used by officers for the CAIF at risk, given the due diligence was conducted for the Pension Fund and its requirements.

39. The Pension Fund has invested with Partners Group since 2014 having invested in a total of five previous private debt fund offerings.

40. The current fund (MAC 6) has a life of seven years and as such the CAIF would expect a return in around 2027-2028 of all monies and investment returns. The money invested by Partners Group and expected profile of returns is best illustrated below.



41. Key features of the fund include:

- a target return of SONIA + 4-6% over the life of the investment. SONIA being the Sterling overnight index average, which is the effectively the overnight interest paid by banks for lending. A cash yield once fully invested of 3-5% per annum,

- a minimum of 80% of loans by value to be senior secured loans. These are loans that offer high levels of security to the investor. The majority of the loans will be to private business (50%-90%). There will be an allowance of up to 30% for opportunistic loans where the expected return would be higher owing to higher risk. In summary, a safe product within the private debt universe but one that does come with investment risks,

- a wide geographic allocation covering Europe (25%-70%), North American (25%-70%) and rest of world (0-30%),

- when fully invested the fund should consist of around 50 private market investments,

- it is an illiquid product; as such the funds would be expected to be invested for the full term,

- it is expected to close for new funds by the end of the calendar year having been open for investments since the second half of 2020. As such any money committed will be invested without having to wait for the pipeline of investments to be built by the Partners Group and money to be called over a period of time,

- a management fee and performance fee payable, which are in line with those currently paid by the Pension Fund.

- cash resources exist to invest without needing to divest and the CAIF can invest in private debt under the current treasury management policy without directing funds away from capital resources.

Proposed Investment - JP Morgan IIF

42. This proposal to invest £7.5m is in line with the Hymans 2020 advice to initiate an allocation to core / core plus infrastructure as described within the Hymans review section earlier. This proposed investment is new to the CAIF which diversifies the risk away from the largely directly owned property portfolio. The key features of the investment and its defensive qualities are described below.

43. Performance monitoring for this proposed investment will be included as part of the regular budget monitoring and to the Scrutiny Commission and the Cabinet via the CAIF annual report.

44. The Leicestershire LGPS also holds two infrastructure funds that are open ended, one of which is the proposed JP Morgan investment. These open ended products have no prescribed end date and therefore no need to manage reinvestment of returning capital.

45. At the October 2020 investment subcommittee a decision was made to top up the infrastructure allocation using the JP Morgan product. The pension fund first invested with the JP Morgan product in July 2016, the since inception returns have been in line with expectations.

46. Returns in the base currency (USD) of the JP Morgan fund over 1, 3, and 5 years are 10.3%, 7.1%, and 7.3% as at 30 June 2021. The cash yield over 1, 3 and 5 years has been 6.0%, 6.9% and 5.8%. Timeframes longer than one year show annualised numbers.

47. Key features of the fund include

    - it is a long-standing strategy, having been founded in 2006,
    - it aims for a target return of 8-12% net and a cash yield of 5-7% of net asset value with income being distributed (these returns are possible due to leverage employed which at June 2021 was 55%),
    - it is open-ended so has some liquidity but comes with a queue to invest of about nine to twelve months owing to the current popularity,
    - it is highly diversified with over 600 individual assets in over 20 countries with the majority invested within the US, Western Europe and the UK,
    - it aims to invest between 30-60% into regulated assets, 30-60% into contracted / power assets and 10-30% into GDP sensitive assets (as at June 2021 the actual splits were 30%, 38% and 32%),

- the investment is US Dollar based, and as such exchange risk is present.

48. Whilst LGPS Central were launching an infrastructure product they completed research into the JPM IIF product. It was not selected as a constituent of their offering as a result of a number of funds already having exposure and therefore were less likely to invest into their pooled offering. The County Council is using the LGPS Central research, again at risk, given it was undertaken for a different purpose albeit only in the recent past. Officers have seen the scoring matrix in which JP Morgan scored very highly versus the other researched funds with their research covering the following areas:

    a) Responsible investing / ESG (Environmental, Social, and Governance)
    b) Team, leadership and experience
    c) Track record and history of capital deployed
    d) Geographic footprint
    e) Strategy, focus and investment process
    f) Management fee and term

49. LGPS Central did rate the product highly enough to warrant setting up a separate infrastructure sleeve offering only the JPM IIF holding for those pension funds who do want a new exposure.

50. Management fees are in line with the LGPS aggregation discount which JP Morgan stated the Council would also benefit from. Fees are charged only once capital is drawn and not when committed. There is a performance fee which is again in line with the pension fund and wider sector.

51. Given the long term nature and illiquid nature of underlying assets JP Morgan operates a ‘soft lock’ where investors can redeem within 6 years, but must pay a 3% admin fee to the fund.

52. Related to this proposal is the Hymans’ advice to reduce the holding in pooled property. Officers will analyse which of the three open pooled funds to reduce to maintain a balanced sector allocation. If timed well the CAIF will reduce pooled property and minimise the time before capital is called by the infrastructure proposal.

Conclusion

53. The private debt investment is an investment the CAIF first made in 2017 into a previous fund offered by the same investment manager, Partners Group. That investment is now returning money to the CAIF.

54. Both proposed investments (Partners Private Debt MAC 6 and JP Morgan IIF) are investments held within the Leicestershire LGPS and as such monitoring is performed on a standard quarterly timetable. Valuations and returns relating to the proposed CAIF investments will be reported to the Cabinet via the CAIF annual report.

55. The proposed infrastructure investment with JP Morgan contains renewable assets, in particular solar and onshore wind, these total a considerable weighting of the fund; circa 22% at 30 June 2021. The target cash yield is 5%-7% per annum and has defensive qualities given the make-up of underlying investments which include critical regulated and contracted assets offering inflation protection.

56. Investment risk does exist however both investment proposals display defensive characteristics as described within the respective proposed investments key features and are targeting the lower return (and risk) parts of their respective markets.

Equality and Human Rights Implications

57. There are no equality or human rights implications arising from the recommendations in this report.

Risk Assessment

58. Both proposals do contain an element of investment risk but have defensive qualities to mitigate. Both proposals are held by the Leicestershire LGPS and will be monitored on a regular cycle by officers of the LGPS fund and the Fund's advisor Hymans at the annual strategy review.

Background Papers

Report to the Cabinet on 5th February 2021 "Revised Corporate Asset Investment Fund Strategy 2021 to 2025" and minutes of that meeting - http://politics.leics.gov.uk/ieListDocuments.aspx?CId=135&MID=6440#AI66682