Leicestershire County Council

INVESTMENT SUB-COMMITTEE – 11 OCTOBER 2023

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

RECOMMENDED INVESTMENT TO PRIVATE EQUITY PRODUCTS

Purpose of report

1. The purpose of this report is to seek approval from the Investment Sub-Committee (ISC) in respect of private equity (PE) commitments covering 2023/24 and 2024/25.

Policy Framework and Previous Decisions

2. The annual strategic asset allocation (SAA) review is presented for approval each year and recommends high level asset allocation changes for the Fund. The latest SAA was approved at the 20 January 2023 Local Pension Committee, where a high-level target for private equity was set at 7.5% of total Fund assets. There is no change to this target from the previous year. As of 30 June 2023, the actual weighting to this asset class was 7.4%. A background paper is included as an appendix to the report.

Background

3. Private equity is an illiquid asset class, with investors required to commit capital for ten years or more. The commitments made to a fund of funds (FoF) PE manager are called by the underlying managers that the Adams Street Partners (ASP) team commit to. ASP's global funds programme is an annual vintage which the Leicestershire Fund has committed to nine times over the last decade or so with a total commitment of $295million.

4. The Fund last invested into an ASP global fund in 2020 totalling $26million. One further investment was made in 2022 to the ASP global secondary fund 7 for $38million, which invests in a smaller niche area of PE called secondary investments.

5. The LGPS Central PE vintages are similar in nature, investing with PE managers and each new vintage currently planned to launch every 18-24 months. The Fund has previously committed to the 2018 and 2021 programme. The total amount committed to the two previous Central vintages totals £40million.

6. The Fund's primary PE exposure comes from ASP £387million. The £40million committed to Central is still in the process of being invested and as such currently totals £8m. The Fund also has a smaller exposure to PE from a legacy manager totalling £29million at the latest valuation date, this will reduce over time as capital is returned to the Fund.

Current strategic asset allocation and cashflow

7. As previously mentioned, the current allocation is close to the target 7.5% allocation. However, in order to maintain this allocation, new commitments (and more importantly calls from the underlying managers) need to match the distributions made to the Fund as PE managers return capital at the end of the investment term.

8. The commitment to PE is being recommended as a result of assessing and maintaining a steady allocation to this asset class. Given the lengthy time taken between a commitment to a PE manager and the money becoming fully invested, forecast commitments and distributions need to be taken into account in order to not fall too far away from the target allocation given realignment isn't easily achievable.

9. This forecast has been carried out by officers and the Fund investment advisor Hymans which has underpinned the level of recommended commitments. It is important to note that both the forecasted commitment and distributions are both subjective and market conditions will impact on the accuracy of the forecasted cashflows.

10. Where investment markets are volatile, PE managers may find it difficult or less attractive to sell their underlying holdings and distributions may be delayed from those forecasted for example.

Current composition of the Fund's PE exposure

11. Hymans have reviewed the Fund's current exposure to PE strategies by lifecycle and origination channels versus what they consider to be optimal. PE lifecycles include venture, growth and buyout with lower risk and return as companies become mature and closer to public market listings.

12. Hymans have also reviewed the origination channels and conclude that the majority of investments should be made via primary funds, such as those being recommended within this paper. Hymans do state, however, that other origination channels, notably co-investments and secondaries, should be considered where appropriate with a target split as described in the table below:

Origination channel	Target allocation	Current allocation
Primary funds	40% - 60%	68%
Co-investment	15% - 25%	16%
Secondary funds	10% - 30%	17%

13. Hymans recognise the current small overweight to the primary funds channel and have advised that future commitments can be made to move the overall allocation towards targets commencing from the 2024 PE commitments as advised later in this paper.

14. Co-investments provide opportunities to invest alongside primary fund managers in individual companies. They enable the manager to invest in opportunities that are too large to accommodate in their primary fund. They are usually single company investments, but for investors with large, well-diversified portfolios, the increase in

concentration risk is not usually significant. The Fund has exposure to co investments via the ASP global funds programme which allocates to all three origination channels, primary funds 65%-70%, co investments 15%-20% and secondaries 20%-25%. The Fund also has exposure to co investments and secondaries via standalone ASP funds.

15. A secondary market in PE investments has arisen as the only way for individual investors to make an early exit from their private equity commitments. ASP Private Equity Secondary funds are built up of multiple purchases of existing private equity funds, including some ASP already own within their other funds. Funds on the secondary market are usually bought at a discount to the net asset value by virtue of the prevailing market conditions. Sellers could be institutions who require cash to fund other investments or benefits, or are merely exiting to satisfy a new target weight in a revised strategic asset allocation. ASP have relationships with the private equity managers that allow, in some cases, exclusive access to these sellers. In any case the relative illiquid nature of the market can provide attractive buying opportunities.

Recommendation summary

16. Hymans rate the current ASP global funds and co investment strategies as preferred (their highest rating). They do not formally rate the Central PE offering but undertook due diligence of the 2021 programme when £30million was committed to the 2021 Central PE vintage and no major issues were identified. At the time Hymans raised minor concern around turnover in the leadership of the private markets team and risk of investing in a fund with little track record. Since then, more PE investments have been made and the team has grown. Resource has been added to the private markets team that can be shared across a number of asset classes.

17. Hymans note the track record within their paper for the 2018 vintage with underlying funds performing satisfactorily at this early stage. The 2021 vintage is too early for any meaningful performance assessments to be made.

18. Hymans have reviewed the third vintage of the Central PE programme and note the following mandate changes which they are comfortable and/or supportive of:

    a. increased exposure to growth and smaller buy-out opportunities, given these markets have historically offered better returns than large/mega buy-outs with less risk than venture capital.

    b. In terms of the Developed Asia exposure, we understand there are interesting opportunities to be found in these markets and the risks need not be higher. But the opportunity set is materially smaller than Europe or North America, so we are comfortable with the proposed reduction in target allocation. We note the proposed allocation range still provides LGPS Central with significant flexibility.

    c. They remain comfortable with the investment restrictions which have not changed. We have previously suggested setting a limit on the maximum exposure to individual economic sectors given the tendency of primary funds in recent years to focus on just three: IT including fintech, life sciences/healthcare and business services. But LGPS Central has confirmed its aim to construct a well-diversified portfolio and to scale back commitments to any primary fund which had a particularly narrow economic focus.

19. Hymans do note the following however, but overall are supportive of the changes and state the Central offer remains a suitable investment for the Fund.

    a. The lack of exposure to venture and secondary will become an issue for future vintages as the Fund's other investments are realised, given that venture now accounts for a significant percentage (20%+) of the overall private equity market.

    b. They note there has been a material, and further, relaxation in manager/fund selection criteria presumably to allow for exposure to smaller, more specialist managers and/or newer strategies. Central state their rationale for relaxing the constraints on manager's total assets and previous fund size are to provide exposure to specialist strategies offered by experienced managers who would previously have co-mingled them within their main funds. Hymans state they are supportive of gaining exposure to such "carve out" strategies, although we note it will make the portfolio management task more complicated.

20. Based on the requirement to maintain a steady state of annual commitments to avoid investing too heavily in any one-year Hymans propose a £80million investment in each of 2023 and 2024. This is recommended to be split as follow:

<table>
<tr><th>Investment vehicle</th><th>£m 2023/24 commitment</th><th>£m 2024/25 commitment</th></tr>
<tr><td>ASP global funds 2024 vintage</td><td>$49million USD</td><td rowspan="2">£80million with exact split by Fund to be determined via framework below and in conjunction with the investment advisor.</td></tr>
<tr><td>Central PE 2023 vintage</td><td>£40million GBP</td></tr>
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21. The allocations to PE over the next couple of years are forecasted to be high and have been verified by Hymans Robertsons expected distributions from the ASP portfolio. Were the distributions delayed then the Fund will have over committed in one or two years.

22. Hymans note that the Fund should maintain a PE portfolio with geographic, economic sector, lifestage (venture, growth and buy out) diversification and continue to make regular commitments to maintain vintage year diversification. They also state that the majority of investments should be made via primary funds but other channels such as co investments and secondaries should be considered where appropriate.

23. A portfolio mix is provided by Hymans as part of their paper and is shown below. It will be used when proposing the mix of PE commitments for 2024/25. This framework approach is similar to the ones proposed for infrastructure, property and private credit and allows officers to monitor mix within an asset class to maintain diversification.

Segment		Target Allocation, %
Geography	North America	30-60%
	Europe	20-40%
	Asia Pacific	10-30%
	Emerging Markets	0-10%
Lifestage	Venture	10-30%
	Growth	10-30%
	Buy-out	40-70%
	Special Situations	0-10%
Origination channel	Primary funds	40-60%
	Secondaries	10-30%
	Co-investments	15-25%

Source: Bain Capital 2022, Hymans research
Special Situations includes private debt, distressed debt and other opportunities. Hymans note a limited allocation as not the primary aim of PE and the Fund has exposure elsewhere in its portfolio

24. Hymans also note Central have made a good start to co investment but they conclude the larger team is still too small to make a material number of co investment investments and as such do not recommend committing to the co investment 2023 sleeve. They note further that the primary fund at Central does not provide access to co investments or secondary funds and as such the Fund should consider making commitments to ASP funds which do in in line with the framework.

Consultation

25. Strategic Asset Allocation (SAA) 2023 – approved at the 20 January 2023 local pension committee meeting.

Resource Implications

26. The Director of Corporate Resources has been consulted. There are no additional resource implications.

Recommendations

27. It is recommended that general cash balances fund the below which will be called over a number of years:

a. £40million (GBP) be committed to the LGPS Central PE 2023 vintage
b. $50million (USD) be committed to the ASP Global Funds 2024 vintage
c. A combined £80million be committed to PE in 2024/25 with the split by PE Fund to be decided based on the geography, lifestyle origination channel framework as described in this paper and with consultation with the Fund's investment advisor.

Background papers

28. 20 January 2023 Local Pension Committee, Annual Review of the Asset Strategy and Structure – https://politics.leics.gov.uk/ieListDocuments.aspx?CId=740&MId=7201&Ver=4

Circulation under the Local Issues Alert Procedure

29. None.

Equality Implications/Other Impact Assessments

30. The recommendation is a high-level strategic document and there are no direct Equality and Human Rights implications. The Fund takes into account issues around Equality and Human Rights as part of responsible investment which incorporates environmental, social and governance factors in all investment decisions. The Fund will not appoint any manager unless they can show evidence that responsible investment considerations are an integral part of their decision-making processes. This is further supported by the Fund's approach to stewardship and voting through voting, and its approach to engagement in support of a fair and just transition to net zero.

Human Rights Implications

31. This paper outlines the approach the Fund is taking with PE. This will align with the Fund's Responsible Investment approach as set out in the Principles for Responsible Investment.

Appendices

32. Appendix – Hymans Robertson Private Equity commitments 2023

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