Item 4(a)

4th September 2019

Glasgow City Council

Strathclyde Pension Fund Committee

Report by Director of Strathclyde Pension Fund

Contact: Ian Jamison, Investment Manager, Strathclyde Pension Fund, ext. 77385

Direct Investment Portfolio (DIP)
Investment Proposal – Equitix Fund VI

Purpose of Report:

To set out a proposal for an investment of £50m within the Direct Investment Portfolio.

Recommendations:

The Committee is asked to **APPROVE** an investment of £50m in Equitix Fund VI by the Direct Investment Portfolio.

Ward No(s):	Citywide: ✓
Local member(s) advised: Yes ☐ No ☐	consulted: Yes ☐ No ☐

1 Background

1.1 Portfolio Establishment

In December 2009, the Strathclyde Pension Fund Committee agreed to establish a New Opportunities Portfolio (NOP) with a broad remit to invest in assets for which there was an attractive investment case but to which the current structure did not provide access.

1.2 Review

The NOP strategy was reviewed in 2012 and in 2015. It was re-branded as the Direct Investment Portfolio (DIP) in 2015. The most recent review of the DIP strategy and operating arrangements was concluded in December 2018.

1.3 Implementation Framework

DIP investment proposals are assessed on their own merits within an agreed implementation framework based on SPF's overall risk-return objectives and specific DIP parameters.

The framework agreed at the 2018 review is summarised below.

Direct Investment Portfolio	
Objectives	Primary objective identical to overall SPF investment objective. Secondary objective of adding value through investments with a positive local, economic or ESG (environmental, social, governance) impact.
Strategy & Structure	In line with SPF risk-return framework but focused on the UK and Equity, Long Term Enhanced Yield and Short Term Enhanced Yield asset categories.
Risk and Return	Portfolio benchmark return of **CPI +3% p.a.** Individual risk and return objectives for each investment.
Capacity	Target allocation of **5%** of total Fund (based on Net Asset Values). Range of **2.5**% to **7.5%** of total Fund.
Investment Size	Target: **£20m** to **£100m** Minimum: **£10m** Maximum: greater of **£200m** or **1%** of Total Fund Value.
Decision Making	3 stage process with review and satisfactory due diligence by officers, followed by a presentation to the Sounding Board before a proposal is taken to Committee for approval subject to completion of legal documentation.
Monitoring	Includes individual investment reports, participation in advisory boards, and a quarterly DIP monitoring report which is reviewed by the Fund's Investment Advisory Panel

The following proposal has been assessed using this framework and is considered appropriate for recommendation to the Committee.

2 New Investment Proposal

2.1 Key Terms

Name	**Equitix Fund VI**
Investment vehicle	English Limited Partnership
Manager	Equitix Investment Management Limited
Sector	Infrastructure
Investment objective	To build a diversified portfolio of infrastructure assets in the UK, with the aim of delivering stable, inflation-linked cashflows to investors
Term	25 years
Target size	£1bn / Hard Cap £1.5bn
Proposed DIP investment	£50m
Target return	Internal Rate of Return (IRR) 7%-10% (Net) with a Cash Yield of 4%+ p.a.

2.2 Investment Summary

Equitix Investment Management Ltd ("Equitix") is a specialist manager of core infrastructure and energy efficiency assets predominantly located in the UK. It has extensive experience of originating, developing, acquiring and managing infrastructure assets through various business cycles.

Equitix is currently raising its 6th infrastructure fund ("Fund VI" or "the Fund"), which is targeting total commitments of £1bn with which to fund the acquisition of a portfolio of 40 to 50 equity investments in the small to mid-market segment of the infrastructure market. The Fund aims to deliver long-term, stable cash yields and capital protection to its investors.

An investment of £50m by DIP in Equitix Fund VI is proposed.

DIP has previously invested £30m and £50m in Equitix Funds IV and V respectively. The performance of both those funds is progressing very well.

Note that an additional investment of £50m in Equitix SPF Co-investment Fund is also proposed. That is the subject of a separate report.

More information on the investment manager is included in **Schedule 1.**

2.3 Investment Rationale

Fund VI will seek to provide investors with a steady cash yield over its 25 year life by investing in lower risk (or "core") infrastructure assets. These would be expected to generate long-term, inflation-linked revenues underpinned by availability based contracts with central/local government, other public sector bodies, or regulated entities with relatively low default and/or financing risk.

As with its previous funds, Equitix will focus on acquiring long term, core infrastructure assets which exhibit the following characteristics:-

- assets which provide essential or critical services to the population;
- are fundamental to a country's long–term economic growth;
- have a stable legal and regulatory environment;
- have high barriers to entry;
- have revenues which are contracted, inflation-linked and availability based (i.e. which are not reliant on the level of usage of the asset); and
- which are anticipated to demonstrate a relatively high degree of revenue stability and low volatility of returns.

The Fund will target assets in the healthcare, education, social housing, transportation, telecommunications, utilities, student and government accommodation, energy from waste, and renewable energy sectors. It anticipates acquiring a portfolio of 40 to 50 equity investments costing between £5m and £100m each with an average of £15m / £25m.

As with its predecessor funds, Fund VI will focus predominantly on the UK market (minimum 90%), however with Equitix's recent launch of a European infrastructure fund, the balance (maximum 10%) will be deployed in certain other non-European, OECD countries such as the USA, Canada and Australia, on an opportunistic basis.

Equitix anticipates acquiring stakes in small to medium sized assets which are too small for global infrastructure funds and which are therefore not subject to the same level of competitive pressure that exists at the larger end of the market, thereby generating relatively higher returns.

Fund VI will acquire investments in both primary and secondary markets, though exposure to primary assets is restricted to a maximum of 20% of the Fund. It is important to note that the development risk of primary opportunities is assumed by a separate Equitix vehicle, with Fund VI having the option to acquire the asset at the post development / pre-construction stage.

Despite having typical investment periods of 5 years, all previous Equitix funds to date have been fully committed and cash yielding within 2 years of their respective first closes (including Fund V which is scheduled to commence distributions by the end of 2019).

Equitix currently has a well-developed and active pipeline of both primary (£945m+) and secondary (£3.3bn+) opportunities to consider for potential allocation to Fund VI and the manager remains confident in its ability to originate attractive opportunities and deploy funds at a good pace.

The first close for Fund VI is scheduled for the end of Q3 2019 with Equitix currently anticipating initial commitments of £400m+ from a variety of pension funds, insurance companies and other investors including many existing investors in prior funds. Equitix will invest 1% of the total commitments (£10m assuming the target fund size is achieved).

2.4 Risks

The main risks of the proposed investment are considered to be as follows:

- Origination Risk;
- Construction / Operational Risk;
- Lifecycle Costs;
- Risk of Termination of Projects / Nationalisation; and
- Brexit.

A summary of risks and key mitigants is contained in **Schedule 2**.

2.5 Projected Return

The target return for Fund VI is a net IRR of between 7% and 10% with a Cash Yield of 4%+ p.a. This is appropriate for a portfolio of mainly operational and lower risk UK infrastructure assets. The level of potential volatility is expected to be modest.

2.6 Exit

Fund VI has an investment term of 25 years although this may be extended with investors' agreement. The Fund has a 5 year investment period although it is expected that the funds will be deployed well within this time.

2.7 Fees

Fees are in line with DIP's current experience in the infrastructure market. The management fee is weighted towards the invested capital, rather than the committed capital during the investment period.

SPF will benefit from modest discounts in the management fee by virtue of the size of the proposed commitment and also for investing at first close.

Carried interest provisions also apply.

It is not anticipated that Equitix will have any significant difficulty in raising the full targeted fund size of £1bn.

2.8 Environmental Social and Governance Issues

Equitix has developed strategies to meet and exceed environmental, social and governance ("ESG") expectations in the markets in which it operates. It does this by incorporating ESG considerations at each stage of the investment process from the initial appraisal and decision-making process to the regular consideration of ESG factors during the life of the assets.

In this way Equitix manages the corporate governance of the assets it owns while regularly reviewing its ESG investment policies to ensure they remain relevant, up to date and aligned with the evolving needs of investors.

Equitix has been a signatory to the PRI (UN Principles of Responsible Investment) since 2010 and is also a member of the UK Sustainable Investment and Finance Association.

2.9 Investment Size and Cash Requirements

SPF Fund value at 30th June 2019	£22.72bn
DIP allocation (target 5% of main fund) NAV	£1,136m
Current DIP NAV	£ 746m
Headroom v NAV	**£ 390m**

2.10 Investment Strategy

The proposed investment falls within the Infrastructure / Renewable Energy sector and therefore the Fund’s long term enhanced yield allocation. Infrastructure (renewable energy infrastructure in particular) is a key area of investment focus for DIP.

Allocations following this investment, based on Fund values at 30th June 2019 and total DIP commitments to infrastructure / renewable energy, would be as follows:

Infrastructure / Renewable Energy, £ in DIP	£786m
Infrastructure / Renewable Energy, % in DIP	62%
Infrastructure / Renewable Energy, % Total Fund	5.6%
LTEY, % Total Fund (target 20%)	16.1%

3 Policy and Resource Implications

Financial:	Investment of £50m to be drawn as required. Overall the fees are in line with market.
Legal:	The investment will be subject to satisfactory completion of due diligence, including review and execution of appropriate legal documentation.
Personnel:	None.
Procurement:	None.
Council Strategic Plan:	Strathclyde Pension Fund aligns with the theme of a well governed city.

Equality and Socio-Economic Impacts:

Does the proposal support the Council's Equality Outcomes 2017-22	Equalities issues are addressed in the Fund's responsible investment policy.
What are the potential equality impacts as a result of this report?	No specific impact from this proposal.
Please highlight if the policy/proposal will help address socio economic disadvantage.	An element of the proposed fund is anticipated to be invested in healthcare, education and social housing assets.

Sustainability Impacts:

Environmental:	See section 2.8
Social, including Article 20 opportunities:	See section 2.8
Economic:	See section 2.8

Privacy and Data Protection impacts:	To be fully provided for in the legal documentation for the proposed investment.

4 Recommendation

The Committee is asked to **APPROVE** an investment of £50m in Equitix Fund VI by the Direct Investment Portfolio.

Investment Manager: Equitix Investment Management Limited

Equitix was established in 2007 to develop and manage portfolios of infrastructure assets for institutional investors. Since then it has raised over £2.9bn through 7 funds (5 core infrastructure and 2 energy efficiency funds). Including co-investment capital deployed, Equitix now has Assets under Management (AUM) of over £4bn.

The Manager has a proven track record of raising and successfully investing capital from local authority and private sector / corporate pension funds, insurance companies and other investors into core infrastructure assets.

The senior management team at Equitix are highly experienced infrastructure practitioners, having been actively involved in the sector since the inception of PPP in the UK. They have each previously held senior managerial positions with some of the largest global infrastructure institutions and have been key to the firm's successful record of securing, developing and operating more than 250 core infrastructure projects under the various Equitix funds.

The broader Equitix team currently comprises over 95 multi-discipline infrastructure specialists organized along functional lines, namely: primary bidding and development; deal origination; finance; asset management; investor relations; and support functions. The team comprises professionals from a variety of backgrounds including construction, project management, facilities management, banking & finance, property legal and the public sector. In this way Equitix believes it has the required in-house skillsets necessary to operate across the lifecycle of a core infrastructure project from origination and due diligence process to the long term management of the asset.

Equitix has a strong track record of creating multiple, diversified portfolios of high-quality primary & secondary investments in its core infrastructure funds, which are delivering strong cash yields to investors. Its asset management team continues to implement the applicable post acquisition, asset management strategies across all funds / assets to generate efficiencies and/or economies of scale, in order to optimize investor returns over the respective fund lives.

Equitix Investment Management Limited is authorised and regulated by the Financial Conduct Authority (the "FCA").

Schedule 2

Risks Summary

Origination Risk
The Equitix management team is extremely well established in the infrastructure marketplace and as such benefits from seeing a steady pipeline of opportunities. Equitix currently has sight of over £4bn of investment opportunities with a track record (and expectation) of winning a good proportion of these.

Construction / Operational Risk
With all infrastructure projects / assets, there is a risk that the contractual &/or warranty arrangements with the design and construction subcontractors may not be as effective as intended. Recourse may also be subject to liability restrictions or the insolvency of a main construction (or facilities management) contractor, as seen recently with Carillion & Interserve. Measures such as performance bonds, contract retentions and latent defects provisions are always incorporated into the legal documentation, however the failure of these two companies has served to highlight the real risks in this respect as well as the level of ongoing contingency planning required to be undertaken by fund managers operating in the sector.

Lifecycle Costs
During the lifetime of each asset concession, certain components of the facility will require replacement or refurbishment, the timing of which is based on forecasts. Shorter than anticipated lifespans or higher than anticipated costs, if not recoverable from the subcontractor concerned, may result in higher lifecycle costs for the asset holding entity. A full technical review of the lifecycle cost provisions for each asset is undertaken pre-acquisition.

Risk of Termination of Projects / Nationalisation
Under PPP projects, the employer and the project entity typically have the right to terminate a project agreement under certain circumstances and the compensation payable (if any) depends on the reason for the termination. A full review of the termination provisions of each asset is undertaken as part of the due diligence ("DD") process. The Manager has also undertaken further legal DD to review the contractual protections in the event of the potential nationalisation of certain infrastructure assets.

Brexit
Core infrastructure investments are defensive in nature in times of political and economic uncertainty and offer investors predictable, long term, inflation-linked contracted cashflows. There is a fundamental requirement for high ongoing levels of infrastructure expenditure in the UK, which will not change under any of the potential Brexit outcomes. Clearly, however, neither the current uncertainty, nor the likelihood of disruption post-Brexit, in whatever form it takes, is helpful to the sector.