Item 4(b)

4th September 2019

Glasgow City Council

Strathclyde Pension Fund Committee

Report by Director of Strathclyde Pension Fund

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Direct Investment Portfolio (DIP)
Investment Proposal – Equitix SPF Co-investment Fund

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 SPF Co-investment Fund 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 SPF Co-investment Fund
Investment vehicle	English Limited Partnership
Manager	Equitix Investment Management Limited
Sector	Infrastructure
Investment objective	To facilitate the acquisition of additional co-investment stakes in larger UK assets, alongside either Fund V or VI, with the aim of delivering stable, inflation-linked cashflows to SPF
Term	25 years
Target size	£50m
Proposed DIP investment	£50m
Target return	Internal Rate of Return (IRR) of 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 6^{th} infrastructure fund ("Fund VI"), 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.

The firm is periodically also presented with other attractive opportunities which are too large for the main fund concerned, due to concentration restrictions. In these situations, Equitix offers the balance of such stakes to co-investors, who actively want to have increased exposure to such assets.

An investment of £50m by DIP in Equitix SPF Co-investment Fund ("CIF") is proposed. This is additional to a proposed investment of £50m by DIP in Equitix Fund VI (which is the subject of a separate paper).

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

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

2.3 Investment Rationale

Equitix's Funds V and VI seek to provide investors with a steady cash yield over their respective 25 year lives 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.

Equitix focuses 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.

Equitix funds target assets in the healthcare, education, social housing, transportation, telecommunications, utilities, student and government accommodation, energy from waste, and renewable energy sectors. Each fund typically acquired a portfolio of 40 to 50 equity investments costing between £5m and £100m each with an average of £15m / £25m.

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, as well as co-investment opportunities of £5bn+. They remain confident in their ability to originate attractive opportunities and deploy funds at a good pace.

2.4 Co-investment

Co-investment is an additional investment in an individual asset made by a portfolio investor alongside a portfolio investment in that asset. SPF has successful co-investment programmes within its private equity portfolios. In December 2018, the Committee agreed that DIP should investigate co-investment opportunities in infrastructure.

2.5 Equitix and Co-investment

In general, Equitix acquires stakes in small to medium sized assets which are too small for global infrastructure funds.

The manager is, however, regularly presented with compelling opportunities which are too large for its main funds to acquire in their entirety. This may be due either to pre-determined fund concentration limits which are set to ensure that the main funds are sufficiently diversified, or simply that a smaller stake would be more appropriate for the fund concerned. In these cases, Equitix will offer the balance of that particular asset to one, or more usually a number, of co-investors. These are investors who wish to deploy additional sums into either larger assets or particular sub-sectors of the infrastructure market.

To date the firm has raised £925m in co-investment capital and Equitix anticipates such opportunities continuing to arise in the future.

Individual opportunities often arise at relatively short notice and require a rapid response by potential co-investors. To manage this, it is proposed that SPF should take a portfolio approach. This is consistent with DIP's structure and processes.

2.6 Equitix SPF Co-investment Fund (CIF)

The proposal is to create a CIF solely for SPF. Equitix will have discretion to manage the CIF subject to a number of parameters/restrictions as follows:

- co-investments to be made only in UK assets;
- co-investments to be in assets in which either Fund V or VI is also acquiring a stake;
- co-investments to be a maximum of £15m in any single asset;
- a summary report of the proposed co-investment transaction to be provided to SPF prior to acquisition;
- SPF to have a right of veto of the proposed transaction;
- SPF to have the right to consider "topping up" the co-investment fund in the future (subject to separate Committee approval at the applicable time);
- potential, with SPF consent, for the CIF to invest alongside any successor Equitix main fund (e.g. Fund VII) in the future.

It is unlikely that the transaction veto would be utilised, as only assets which satisfy the investment criteria of Funds V or VI could be considered for co-investment. However, the right of veto, which will be exercised by SPF officers, provides an additional measure of control.

The CIF has been designed to assist SPF to:

- deploy incrementally more funds into infrastructure;
- manage portfolio diversification; and
- take advantage of lower fee structures on co-investments (see below), which will reduce the overall blended cost of the main fund and CIF investment strategies.

2.7 Risks

The main risks of the Equitix strategy are considered to be as follows:

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

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

The proposed investment in the CIF concentrates these risks – i.e. the Fund will have larger stakes in fewer assets in comparison to the Fund VI investment. The mitigants are the same. The manager has experience of running co-investment programmes, and there will still be sufficient diversification within the more concentrated CIF portfolio. Co-investment will also help DIP manage the risk of over diversification.

2.8 Projected Return

The targeted return for the CIF is the same as for Fund VI, i.e. a net IRR of between 7% and 10% with a Cash Yield of 4%+ p.a.

While the targeted return is the same, the actual return (while expected to be similar) will not exactly match that of Fund VI. This is a result of the ability to invest in Fund V as well as Fund VI assets, the greater concentration of CIF assets, and the lower fee which should improve the CIF's net return.

The targeted returns are considered appropriate for a portfolio of mainly operational and lower risk UK infrastructure assets.

2.9 Exit

As with Fund VI, the CIF will have an investment term of 25 years, although this may be extended with SPF's agreement.

2.10 Fees

The management fee for the CIF represents an attractive discount to the fee applicable to Fund VI and additionally only applies to invested capital.

Carried interest provisions apply to the CIF, however various discounts have been negotiated by SPF.

The fee structure for the CIF is considered acceptable.

2.11 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 factors 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.

2.12 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**

2.13 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 (and a £50m investment in Equitix Fund VI), 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	£836m
Infrastructure/Renewable Energy, % in DIP	63%
Infrastructure/Renewable Energy, % Total Fund	5.9%
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 co-investment fund could be invested in healthcare, education and/or social housing assets.

Sustainability Impacts:

Environmental:	See section 2.11
Social, including Article 20 opportunities:	See section 2.11
Economic:	See section 2.11

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 SPF Co-investment Fund by the Direct Investment Portfolio.

Schedule 1

Investment Manager: Equitix Investment Management Limited

Equitix was established in 2007 to develop and manage portfolios of infrastructure assets for investors. Since then it has raised over £2.9bn in 7 funds (5 core infrastructure and 2 energy efficiency funds). Including co-investment capital 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, corporate pension funds & 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, to which it continues to add with primary development opportunities and the acquisition of suitable secondary operating assets.

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 sizeable cash yields to investors. Its asset management team continues to implement the applicable strategies across all funds / assets to generate efficiencies and/or economies of scale, to optimize investor returns over the respective fund lives.

Equitix Investment Management Limited is authorised and regulated by the Financial Conduct Authority.

Risks Summary

Origination Risk
The Equitix management team are extremely well established in the infrastructure marketplace and as such benefit from seeing a steady pipeline of opportunities. Equitix currently has sight of over £4bn of investment (plus £5bn of co-investment) opportunities with a track record (and expectation) of winning a good share 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 contingency planning requiring 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 Project Agreements / 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.