



Glasgow City Council

Strathclyde Pension Fund Committee

Report by Director of Strathclyde Pension Fund

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Item 3

4th March 2020

**Direct Investment Portfolio (DIP)
Investment Proposal – Palatine Private Equity Fund IV**

Purpose of Report:

To set out a proposal for an investment of £25m within the Direct Investment Portfolio.

Recommendations:

The Committee is asked to **APPROVE** an investment of £25m in Palatine Private Equity Fund by the Direct Investment Portfolio.

Ward No(s):

Citywide: ✓

Local member(s) advised: Yes No consulted: Yes No

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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 the 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 has been reviewed by the Committee Sounding Board. It is considered appropriate for recommendation to the Committee.

2 New Investment Proposal

2.1 Key Terms

Name	Palatine Private Equity Fund IV
Investment vehicle	English Limited Partnership
Manager	Palatine Private Equity LLP
Sector	Growth Capital
Investment objective	Investing in the UK lower mid-market with a regional focus
Term	10 years
Target size	£250m (Hardcap £300m)
Proposed DIP investment	£25m
Target return	15%-25% IRR (net)

2.2 Investment Summary

Palatine is a Manchester-based, regionally focused, UK lower mid-market Private Equity investor controlled and owned by its partners who together have over 80 years' experience of sourcing, executing and managing businesses in the UK.

Palatine Private Equity IV LP, an English limited partnership with a target size of £250 million, intends to continue Palatine's proven strategy of focusing primarily on making investments of between £10 million and £30 million in businesses based in the regions of the UK with an enterprise value of up to £50 million. Palatine raised £100 million for its first fund in 2007, followed by £150 million for its second fund in 2013, and £220 million for its third fund in 2015. Palatine closed its debut Impact Fund on £100 million in 2017 – enhancing the firm's proven commitment to ESG and responsible investment.

Fund IV intends to build a portfolio of 12 to 14 investments in the lower to mid segment of the market. The fund will not consider start-ups, early stage businesses or secondary investments.

An investment of £25m by DIP in Palatine Private Equity Fund IV is proposed.

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

2.3 Investment Rationale

Palatine Private Equity is an independent private equity firm managed by its partners, who are based in the target regions and are the decision-makers within the firm. Unlike private equity houses seeking to source and execute deals in these regions from a London base with or without regional satellites, Palatine is based in Manchester, a major

financial centre in the North West of England. Palatine is an established lower mid-market private equity house with its head office located outside of London.

Palatine also has offices in London and Birmingham, which are focused on originating and executing investments in the Southern and Midlands regions of England. Palatine believes that its regional presence, combined with the seniority and track record of the partners, has been important in originating high quality transactions for the prior funds and expects that this will continue for Fund IV.

Palatine has a long, successful track record since Fund I in 2007.

The final close for this fund is scheduled for the end of Q2 2020 with £165 million already committed to the fund in prior closings. Palatine currently anticipate securing commitments of £200m+ from a variety of pension funds and other investors. As well as this Palatine, will invest £7m.

Drawdowns are anticipated from Fund IV in early April 2020 with the expectation that the fund will be fully drawn within 4 years. The current pipeline for the fund shows 3 deals at a value of £62m giving a strong start to the investment period.

2.4 Risks

The main risks of the proposed investment in Palatine's Fund IV are considered to be as follows:

- Sourcing Opportunities
- Private Equity Risk
- Key Personnel

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

2.5 Projected Return

The target return for Fund VI is in the range of 15%-25% IRR (net) which is appropriate for a portfolio of this nature.

2.6 Exit

The Fund has an investment term of 10 years although this may be extended with investors' agreement for up to 2 x 1 year extensions. 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

The management fee and carried interest provisions are in line with market norms for private equity style funds.

The opportunity to negotiate any discount was limited by the forthcoming close being the final one for the fund, and the expectation that the manager will comfortably achieve the full target fundraising.

2.8 Environmental Social and Governance Issues

Palatine has been a signatory to the PRI (UN Principles for Responsible Investment) since 2014.

2.9 Investment Size and Cash Requirements

SPF Fund value at 31 st December 2019	£23.684bn
DIP allocation (target 5% of main fund) NAV	£1,184m
Current DIP NAV	£ 799m
Headroom v NAV	£ 385m

2.10 Investment Strategy

The proposed investment falls within the Growth Capital sector and therefore the Fund's Equity allocation. Equity is a key area of investment focus for DIP.

Allocations following this investment, based on Fund values at 31st December 2019 and total DIP commitments to Growth/Venture Capital, would be as follows:

Growth/Venture Capital, £ in DIP	£168m
Growth/Venture Capital, % in DIP	13.1%
Growth/Venture Capital in DIP as % of Total Fund	0.7%
EQUITY, % Total Fund (target 52.5%)	59.4%

3 Policy and Resource Implications

Financial: Investment of £25m to be drawn as required. Fee structure 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 Equalities issues are addressed in the Fund's responsible investment policy.

*Council's Equality
Outcomes 2017-21*

*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.*

No specific impact from this proposal.

**Sustainability
Impacts:**

Environmental:

See section 2.11

*Social, including
opportunities under
Article 20 of the
European Public
Procurement
Directive:*

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 £25m in
Palatine Private Equity Fund IV by the Direct Investment Portfolio.

Investment Manager: Palatine Private Equity Fund

Palatine is a regional, independent Private Equity (PE) firm founded in 2005 with offices in Manchester (head office), Birmingham and London. It is an established PE firm in the UK lower mid-market (LMM) with a regional focus and a head office outside London, as opposed to a London head office and regional network. Palatine is based in Manchester and its satellite offices in London & Birmingham are focused on executing opportunities in the Southern and Midlands regions of England.

Palatine is led by Gary Tipper who has 25 years of experience investing in the UK regional LMM. Prior to establishing Palatine with partners Ed Fazakerley and Tony Dickin, he was Head of Limited Partnerships at AMJPE (Aberdeen Murray Johnstone PE) where all three worked together. Andy Lees who also worked at AMJPE, joined Palatine as a partner in 2013. Combined, the 4 partners have 80+ years of experience in regional PE.

Palatine believes that its regional focus presents it with certain advantages, namely fewer competitors, leading to lower competition for deals and reduced pricing pressure; strong relationships with locally based corporate finance advisers; and a partner-led model which together with its regional headquarters attracts local entrepreneurs who prefer business partners with local knowledge / presence.

The firm's investment philosophy is to seek opportunities with the potential for "buy-and-build" expansion (either through bolt-on acquisitions or through rolling out a business concept to different areas) and/or significant operational improvements. The firm also has a strong approach to ESG investment management, reflected in its winning multiple responsible investment awards in recent years.

Risks Summary

Investment Specific Risks

Sourcing Opportunities

The ability to originate a pipeline of attractive opportunities in the lower mid-market segment of the UK market is a key factor in the potential success of the fund. Having been established for 15 years with three prior funds, total commitments of £450m and 29 investments, Palatine has a relatively high profile in the regional markets and consequently benefits from a steady flow of referrals from its network of contacts, traditional introducers and new office in Birmingham. There is no reason to believe this will not continue following the relative easing of the political uncertainty in the latter part of 2019.

Private Equity Risk

The proposed investment is to a PE fund, which operates in a relatively risky segment of the financial market with no guarantee of success. A PE fund would traditionally anticipate a number of outright investment losses, a larger number of moderately successful investments and one or two “stellar” investments, which combine to generate the blended / relatively high targeted return. The principal comfort in this regard is Palatine’s track record in its three previous funds which have generated returns to date of 24%, 10% and 30% respectively, with 13 asset exits to date out of a total of 30 investments.

Key Personnel

The risk of over-reliance on key personnel is pertinent to any manager and indeed Palatine consider that they were relatively under-resourced during a growth phase coinciding with their second fund and which partially contributed to the lower return for this fund. This was remedied well in advance of Fund III and indeed further recruitment is envisaged in 2020.

The success of Palatine has been built on a strong team comprising 4 partners (with over 80 years combined PE experience), 22 investment professionals plus further support functions. It is considered that there is sufficient strength and experience in the team to deliver the proposed strategy for Fund IV.