Item 4(b)

7th March 2016

Glasgow City Council

Strathclyde Pension Fund Committee

Report by Director of Strathclyde Pension Fund

Contact: George Finnie, Investment Manager, Ext: 76255

Direct Investment Portfolio (DIP) Investment Proposal: SEP V

Purpose of Report:

To set out a proposal for an investment of £20 million within the Direct Investment Portfolio

Recommendations:

The Committee is asked to **APPROVE** an investment of £20 million in SEP V within the Direct Investments Portfolio

Ward No(s): Citywide: ✓

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

NEW PROPOSAL – INITIAL EVALUATION

Proposal	–	SEP Fund V
Date Received	–	December 2015
Source	–	Direct from SEP
Committee Sounding Board	–	February 2016
Type of Transaction	–	Scottish Limited Partnership
Total Investment Target	–	£250m
DIP Amount Proposed.	–	£20m
Proposed Return	–	Net IRR target 20 %

1.Nature of Proposed Investment	Scottish Equity Partners ("SEP") is a Scottish fund manager which has its roots in Scottish Enterprise but which was established independently in 2000. Its original focus was the provision of venture capital to technology focussed investments but the focus has gradually moved to larger and more developed growth capital opportunities. The investment approach continues to be based on thorough mitigation of market and technology risk, investing in companies with clearly defined capital requirements and a clear exit strategy. Since 2000, SEP has established SEP II, which was dedicated to early stage venture capital, and SEP III and SEP IV, both of which have focused on growth stage investments. It has also raised two environmentally focussed funds. SPF has invested in SEP I, II, III and IV and also SEP's Environmental Capital Fund during that time. The proposed fund size for SEP V is £250m and it will invest in between 15 to 20 companies operating in sectors such as internet consumer services, cloud-enabled software, healthcare IT and energy efficiency. Recent successful investments in SEP III and IV include:- **Skyscanner** – online travel search which now employs over 700 people in Scotland and Asia **Anesco** – UK's leading energy efficiency provider **Mister Spex** – Europe's largest independent online eyewear retailer **Zuto** – the UK's largest online provider of used car finance.
2.Return – is the proposed return within framework guidelines?	Yes - the proposed return is acceptable for the type of investment envisaged. Our track record with SEP in terms of SEP III and SEP IV suggests that the target should be achievable.
3. Risk – have associated risks and mitigation measures been identified?	The main risks are:- *Ability to source opportunities* – the management team behind SEP is well established in their sector of the market place and as such will see a

	steady pipeline of opportunities. The technology related private equity market remains generally strong and SEP's relationships with advisors in this sector should ensure a continuation of this flow of opportunities. *No assurance of returns* – the proposed investment is into a private equity fund, which operates in a relatively risky market that is reflected in the target return seen above. Our principal comfort in that regard is the track record of SEP in respect of its two recent Growth funds, SEP III and SEP IV. SEP III is a £158m fund, which has made 23 investments and has seen 13 exits from those. SEP IV is a £200m fund and has made 16 investments to date, of which 2 have been realised. *Portfolio concentration* – there is intended to be a common focus to the portfolio, utilising the team's expertise in technological investments but these investments require to exhibit clear commercial opportunities allied to proven and established management teams. Within that core focus there will be a broad diversity of differing types of underlying business, as has been the case in previous funds. *Dependence on key personnel* – the success of SEP has been built on a strong core team and this has been maintained in recent years, with only a couple of senior retirals. There is sufficient strength and experience to deliver the strategy upon which the fund is predicated.
4. Sector – is sector appropriate? Would investment over-expose DIP to that sector? Is the proposed investment consistent with SPF investment strategy?	The proposal is a private equity investment. The underlying basis is provision of growth capital to SMEs (Small and Medium Enterprises). Equity investment to date represents around 12% of DIP commitments, so a further investment of this size will not mean an over-concentration on the private equity sector within DIP. The equity component of the Fund's overall investment strategy is set to reduce over time, but SME equity, venture, growth and development capital will continue to be an important element of that component. The success of previous DIP investments with SEP gives a particularly strong rationale for this proposal.
5. Size – is proposal of an acceptable size?	The proposed lot size of £20m is appropriate both as a proportion of DIP (total capacity £780m) and in the context of the size of SEP V (target £250m). At this level of investment SPF would seek an Investment Advisory Committee place if possible.
6. Cash requirement – is there sufficient headroom in NOP to fund proposal in full?	Yes – there is sufficient headroom within DIP. Before this investment DIP headroom and capacity is:

	▪ £315m headroom as % of commitments ▪ £780m total capacity.
7. Exit – is this defined/acceptable/realistic?	The fund has an expected life of 10 years (with two potential 1 year extensions) and with a 5 -year investment period. Those terms are in line with similar funds in the market. The exit process will be from the sale of individual investments on a structured basis. That is in line with market and should permit a controlled sale process. Market events can affect sentiment and therefore the ability to sell investments but at an average hold of 4 to 5 years there is sufficient time to smooth market peaks and troughs. SEP has demonstrable experience of managing the sales process successfully in previous funds.
8. Geographical Focus - is there any specific local focus?	The fund will mainly seek investment opportunities across the whole of the UK. There will be a small element of flexibility built in to allow the pursuit of European opportunities, most likely in Germany and Northern Europe but that is expected to be by exception.
9. Social issues – are Environmental, Social and Governance (ESG) issues addressed?	The fund will provide capital to SMEs, an important area of economic activity which continues to struggle for finance in the market. SEP has a strong ESG policy and has a stated aim of ensuring that ESG issues are fully considered within its decision-making process. ESG is also a strong part of its due diligence process, as these factors are recognised as impacting on commercial performance.
10. Comments and Conclusion	The opportunity is to invest in a further fund which is being established by SEP. The team at SEP has established an excellent track record in the private equity sector, successfully shifting its emphasis from venture capital to growth capital. The size of each successive fund has grown gradually over time, with the team expressly taking care to raise a fund each time that they feel can be still be successfully deployed over a realistic timescale. The core team at SEP has been together for a considerable time and they continue to build on that with selective recruitment and judicious use of a strong Advisory Board. Performance in prior funds has been very strong and this was recognised at the British Private Equity Awards in 2015, where they were named UK Venture Capital Firm of the Year for the 5th time. The opportunity is in line with the current strategy of Strathclyde Pension Fund and offers an attractive return relative to the risk involved.
11. Policy and Resource Implications	

Financial Legal Personnel Procurement	Investment of £20m to be drawn down as required. Fees and carried interest in line with market. Investment will be subject to satisfactory completion of due diligence, including review and execution of appropriate legal documentation. None None
12. Council Strategic Plan:	Not directly applicable
13. Equality Impacts: EQIA carried out: Outcome:	 No Not applicable
14. Sustainability Impacts: ***Environmental:*** ***Social:*** ***Economic:***	 See section 9. See section 9. See section 9.
12. Recommendation	The Committee is asked to **APPROVE** an investment of £20 million in SEP V within the Direct Investments Portfolio.