

SURREY COUNTY COUNCIL

PENSION FUND BOARD

DATE: 15 MAY 2014

LEAD OFFICER: SHEILA LITTLE, CHIEF FINANCE OFFICER

SUBJECT: PRIVATE EQUITY INVESTMENT PERFORMANCE REVIEW



SUMMARY OF ISSUE:

The Surrey Pension Fund has a commitment to invest 5% of the fund in private equity. This is achieved by investing in funds of funds and directly managed funds, managed by a number of private equity specialists.

The Pension Fund Board reviews the private equity strategy annually. This report is the 2013/14 review.

RECOMMENDATIONS:

It is recommended that:

- 1 The Board note the current position on the Fund's Private Equity investment performance.
- 2 The Fund continue to commit to follow on funds of the existing private equity managers as they become available and subject to each case going to the Pension Fund Board for approval.

REASON FOR RECOMMENDATIONS:

A solid framework of review is required in order to benefit from this long term asset category.

DETAILS:

Background

- 1 Private Equity investment can be characterised by investment in start-ups and early stage companies in order to provide development capital, or capital for management buy-outs (MBO) and management buy-ins (MBI). Many of these small companies that are seeking private equity or venture capital investment are regarded as high risk and cannot raise capital via public listings on the stock markets or borrowing from banks.
- 2 In return for taking the extra risk, private equity investors look for substantial equity and significant influence in the company, possibly through a seat on the company board. Sometimes they provide management and financial administration support to their investee companies. They will look for an exit through a sell on, trade sale or a flotation of the company within two to five years. Private equity investments are a means of achieving diversification, enhancing returns, and spreading risk.

Choosing Private Equity Investments

- 3 There are a number of different options for investing in private equity:
- direct investments;
 - direct investments via a specialist manager;
 - investment in a fund or limited partnership;
 - investment in a fund of funds;
 - and investment in a listed trust.
- 4 Surrey's current strategy is to invest via Limited Partnerships (LP) or Fund of Funds (FoF). Factors to consider when making the decision on which FoF or LP to choose include:
- performance track record;
 - people;
 - investment philosophy;
 - and strategy.

The latter includes an assessment of business alliances, deal flow, sector knowledge, market knowledge and, in the case of FoFs, the ability to access good opportunities.

Governance Arrangements

- 5 Private equity managers provide formal quarterly reports. The Pension Fund and Treasury manager aims to meet with the private equity managers on at least an annual basis to discuss strategy and returns, and also aims to attend all Fund AGMs when they are held.

Performance Measurement

- 6 Private equity performance is measured either by the multiple of capital appreciation (ratio of final realised value to initial cost) or the Internal Rate of Return (IRR), which is more commonly used by institutional investors. IRR is a money-weighted return expressed as a percentage and uses the present sum of cash drawdowns (money invested), the present value of distributions (money returned from investments) and the current value of unrealised investments and determines the effective annualised return of the investment.
- 7 Whilst investing in private equity within a portfolio is a way for long-term investors to diversify their risk (although taking on illiquidity risk) and enhance returns, public and private equity markets are somewhat correlated over the long term. The correlation between public market returns and private equity is estimated to be around 0.7 over the long term. Global private equity has delivered returns of 15.2%, 6.9% and 21.7% for the three, five and ten-year periods to 30 June 2013. This compares with annualised returns of 10.7%, 6.1% and 6.0% for the MSCI World Index over the same time periods (source: Prequin, MSCI).

- 8 An estimate of the IRR of the whole of the Surrey private equity programme gives a return of 14.9% since April 2001, when the first of the current funds was set up. It is known that in the 13 years to 31 March 2014, the FTSE All Share Index returned 2.7% p.a. The target level of return sought was the FTSE All Share plus 2% over the life of the funds, so estimates would suggest that the target has been exceeded.

Surrey Pension Fund Private Equity Strategy

- 9 The Surrey Pension Fund first invested in Private Equity in 1986, initially investing directly in companies on the advice of a specialist manager. More recently the Fund has invested in Private Equity funds, primarily in the UK but also in Europe and globally, the latter predominantly in the US but with increasing emphasis on Europe and the Far East.
- 10 The previous Investment Advisory Group (IAG) considered its overall strategy on Private Equity in October 2000 in the light of an Asset Liability Modelling (ALM) study conclusion that investment be increased to between 3% and 5% of the Fund. This strategy was revisited in December 2008, when it was agreed to invest in follow-on funds offered by the Fund's stable of private equity managers.
- 11 The overall strategy is designed to diversify by manager, vintage year (year of investment), sector, geographically and by investment stage. Decisions on individual private equity investments are delegated to the Chief Financial Officer after approval by the Pension Fund Board. The current strategy is as follows:
- Core UK holdings via ISIS private equity partners
 - Investment in UK through HG Capital funds
 - Investment in Europe through Standard Life Capital Partners Fund of Funds
 - Investment in Global (predominantly US but with increasing emphasis on Europe and Far East) private equity through Goldman Sachs and Blackrock (formerly Merrill Lynch) backed Fund of Funds
 - Investment in Capital Dynamics US solar Fund, which was a new commitment made in 2011/2012

Current Position

- 12 Private Equity investment in Funds involves a commitment (a potential obligation to invest) and subsequent draw downs of cash. Typically, draw downs might average only 75% of the commitment, as Funds may raise more commitments than they invest. The fund is invested both in Fund of Funds (i.e. a selection of funds chosen by a fund manager) and individual funds. The Fund of Funds route is generally less risky for overseas investment, but also enables access to Funds that might not be available to single institutions.
- 13 The private equity strategy ensures compliance with best practice through diversification and the Surrey Fund meets all the CIPFA/Myners principles in this respect. The Fund has made follow on investments in new funds raised by the managers selected. In practice, managers will raise new funds every three years or so. The last follow on commitments were made in September 2013 to Standard Life and Capital Dynamics.
- 14 The detailed position on commitments and cash invested at 31 March 2014 is shown in Annex 1 and is summarised as follows:

	Value	% of Fund
	£m	
Total Commitment	274.4	9.9
Investment (drawn)	167.0	6.0
Commitment Outstanding	107.4	3.9
Distributions Received	93.8	3.4
Fair Value of Remaining Investments	122.5	4.4
Distributions + Remaining Investments	216.3	7.8
Implied Gain	49.3	1.8
Estimated IRR	14.9%	
Total Surrey Pension Fund Value	2,771.1	

Where relevant valuations converted to £ equivalent as at 31 March 2014

- 15 Based on a current market value of £2,771.1m as at 31 March 2014, 9.9% of the Fund is committed to private equity investments. However, the actual level of investment (based on the Fair Value of the remaining investments) is around 4.4% of the Fund.
- 16 A schedule of the private equity investments at 31 March 2014 is shown in Annex 1.

CONSULTATION:

18 The Chairman elect of the Pension Fund has been consulted on the report.

RISK MANAGEMENT AND IMPLICATIONS:

20 Risk related issues are contained within the report.

FINANCIAL AND VALUE FOR MONEY IMPLICATIONS

21 Financial and value for money implications are contained within the report.

CHIEF FINANCE OFFICER COMMENTARY

22 The Chief Finance Officer is satisfied that all material, financial and business issues and possibility of risks have been considered, and that private equity has been a good performing asset class for the pension fund.

LEGAL IMPLICATIONS – MONITORING OFFICER

23 There are no legal implications or legislative requirements associated with this report.

EQUALITIES AND DIVERSITY

24 The review of the Fund's private equity programme will not require an equality analysis, as the initiative is not a major policy, project or function being created or changed.

OTHER IMPLICATIONS

25 There are no potential implications for council priorities and policy areas.

WHAT HAPPENS NEXT

26 The following next steps are planned:

- Review of the strategy by Pension Fund Board.
- Consideration of a further investment opportunity by Pension Fund Board (separate report re Standard Life SOF II).

Contact Officer:

Phil Triggs, Strategic Finance Manager (Pension Fund and Treasury)

Consulted:

Pension Fund Board Chairman

Annexes:

Schedule of Private Equity investments

Sources/background papers:

Private equity manager reports

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