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Review of Private Equity and Infrastructure Investments

PREPARED FOR:

Surrey County Council Pension Fund

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Attendees

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Background

The Surrey Pension Fund has a long history of investing in Private Equity Funds and has more recently begun to invest in Infrastructure Funds. The Fund began making investments in 1999, to date the funds have all been closed-end and has a number of funds that have been or are very close to be fully realised, ie they have completed their life cycle, the committed capital has been drawn, invested, the investments sold and the capital returned to Surrey, either in the form of a capital or income gain.

Unlike publicly quoted equities, which are listed and traded openly on a Stock Exchange, where the price is known in real-time and logged at the end of the day's trading. Private Equity prices are arrived at by "price discovery", this means that at a particular point in time, there is some uncertainty over the price. This price uncertainty is often referred to as the "illiquidity premium", an extra return that is demanded by investors to compensate for the fact that assets cannot be sold quickly and easily as publically listed equity. In the past this "premium" or extra return has varied, but over the long term it has on a net of fees basis been greater than 1% above the return of listed equity markets.

Investment in Private Markets a broader term for Private Equity, Private Debt and Infrastructure can be achieved by investing in a fund of funds, direct funds, co-investing and direct investing. This way some of the risks of this type of investment can be mitigated by diversifying not just at the investee company level but also by the style of manager. Funds can be open ended or closed-end occasionally they are listed on a stock exchange, most often they will be Closed-end and Unlisted. While the fund of funds approach is potentially the most expensive, it does have lower governance requirements, higher diversification and investor access, than most of the other approaches.

The key to success of investment in Private Markets asset is "manager skill", the quality of the research, the ability of the manager to identify good quality companies, to invest not just money but also to provide consulting and / or hands on experience in management, usually the manager will have seat on the Board of the investee company and will be actively engaged in driving forward the strategy and value creation. It is also important that the manager has a stake in the investee companies, investing alongside management and the investors, to ensure the alignment of interests. Other important keys to success include diversifying factors such as Geography, Sector and Vintage.

Most funds are Primary offering closed-end funds, this means the investors can be invested for over 10 to 12 years, once the investor has committed funds they are obliged by contract to deliver the capital when called. Many closed-end funds have a finite life, by which time all the committed capital must be returned to investors, sometimes there is an extension period to enable the sale of assets at a better price or to mitigate general macro-economic conditions.

Listed in the table below are the past and current Private Equity and Infrastructure investments in the Surrey Pension fund listed by Fund Manager and then by Vintage (year of creation).

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Private Equity Fund Manager and Fund Name	Vintage	Fund Status in life cycle	Surrey Commitment	% of commitment drawn	Gross IRR	Net IRR [2]
Aberdeen Standard Investments						
European Strategic Partners II	2002	Fully Realised	E10m	93	17.2%	12.4%
European Strategic Partners 2006	2006	Distributing	E15m	92	7.8%	5.7%
European Strategic Partners 2008	2008	Distributing	E15m	93	13.4%	9.6%
European Smaller Funds I	2012	Value Creation	E17.5m	67	9.8%	5.4%
Secondarieis Opportunities Fund I	2014	Value Creation	US$20m	92	15.5%	13.5%
Secondarieis Opportunities Fund II	2014	Investing	US$20m	82	27.5%	24.5%
Secondarieis Opportunities Fund III	2017	Investing	US$45m	23	n/a	n/a
BlackRock						
DivPEP I	2000	Distributing	US$5m	96	18.9%	13.2%
DivPEP II	2002	Distributing	US$5m	94	14.6%	10.4%
DivPEP III	2005	Distributing	US$17.5m	88	6.9%	4.7%
Capital Dynamics						
LGPS Collective PE Vehicle	2016	Investing	£8m	25	n/a	n/a
LGPS Collective PE Vehicle	2017	Investing	£8m	7	n/a	n/a
Darwin Alternatives						
Darwin Leisure Development Fund	2013	Value Creation	£20m			13.3%
Darwin Leisure Development Fund	2017	Investing	£40m			9.8%
Goldman Sachs						
Private Equity Partners 2000	2000	Distributing	US$9.5m	107		13.9%
Private Equity Partners 2004	2004	Distributing	US$10m	105		7.4%
Private Equity Partners 2005	2005	Distributing	US$17m	100		3.8%
Private Equity Partners X	2008	Distributing	US$18m	91		11.2%
Private Equity Partners XI	2011	Value Creation	US$40m	90		17.6%
Vintage VI Secondaries Fund	2013	Investing	US$20m	79		14.9%
Vintage VII Secondaries Fund	2016	Investing	US$50m	29		n/a
HgCapital						
HgCapital Partners 5	2006	Distributing	£10m	98	16.1%	11.5%
HgCapital Partners 6	2006	Distributing	£10m	94	17.2%	11.8%
HgCapital Partners 7	2013	Value Creation	£15m	94	23.5%	16.4%
Livingbridge						
ISIS II	1999	Fully Realised	£12m		22.0%	17.0%
ISIS III	2003	Fully Realised	£14m		33.0%	24.0%
Livingbridge 4 LP	2007	Fully Realised [3]	£15m		29.0%	18.0%
Livingbridge Enterprise 1 LP	2013	Value Creation	£10m	66	17.0%	12.0%
Infrastructure Fund Manager and Fund Name						
Goldman Sachs						
West Street Infrastructure Partners III	2017	Investing	US$20m	23	n/a	n/a
Pantheon						
Pantheon Global Infrastructure III	2018	Investing	£45m	20	n/a	n/a
Estimated average Net IRR						**12%**

Notes

2) Net Returns are stated after fees and carried interest (where applicable)

3) The fund is fully realised, other than holding £1.4m in escrow following the sale of Autologic.

Performance

From the table above, a simple average of the 22 (out of 29) funds fully or majority invested, shows an estimated return of over 12% pa. While this number is somewhat mis-leading the Net Internal Rate of Return (IRR) for each fund varies between 3.8 and 24.5%, with many showing strong double-digit IRR's. This estimate is somewhat higher than the return available from the publicly listed equity markets over a similar period.

Funds invested with a vintage prior to the Global Financial Crisis (GFC) have consistently achieved IRR's of over 10% with the range 10.4 to 24%. Those funds with a vintage just before and during the GFC have more varied IRR's in a range of 3.8 to 18% and an average just under 10% and those funds of a vintage post the GFC that have been fully, or majority invested have achieved an average return over 10% in a range of 5.4 to 24.5%. There are number of funds that have only recently had capital committed to them, these are marked n/a because there is no meaningful data on performance at this stage.

Where I was able, I have included the gross IRR's to show how expensive some of the fund managers are, but as I mentioned above manager skill and alignment of interests are the keys to success in this asset class. It is also worthy of note that most managers have deployed over 90% of committed capital over the life cycle of the funds.

Adviser View

The reports received from the various managers and my analysis, support the investment thesis that investing in Private Equity does generate higher returns than listed equities to compensate for the lack of liquidity. The same thesis is yet to be proven, but with time investment in infrastructure can also be expected to provide higher returns, more linked to income than growth, if at higher costs, than publicly listed assets for the Surrey Pension Fund. Possibly and more importantly because of the different nature of the private market assets and the investment approaches adopted by the managers, the Surrey Pension Fund enjoys significant risk diversification benefits from its current investments and should probably consider increasing its allocation.

The Surrey Strategic benchmark's asset allocation is already well diversified and contains an allocation to Private Equity, but there is no dedicated allocation to other Private Markets such as Private debt or Infrastructure. These investments are less liquid (more difficult to buy and sell) and require high levels of due diligence to ensure only the best opportunities are acquired. The manager selection process is resource intensive, can be slow and once the manager is selected, deployment of committed cash can take a long time.

Despite this, Private Market assets exhibit many desirable attributes for pension funds whose long term liabilities have call for a balanced portfolio of long term assets whose performance is dependent on diverse sources of risk and return compared to more traditional tradable asset classes such as bonds and listed equities. For instance Private Debt can access higher yielding assets with floating rate yields, thereby reducing the interest rate sensitivity of the Fund and Infrastructure investment can provide a cheaper way to access long term inflation linked cash flows than through index linked gilts.

Private Equity is a very different asset class to listed equity because of the level of active engagement by the manager driving forward the value creation and development of the investee company rather than the hands off approach used when investing in listed equity where the management is trusted to run the business.

Currently the Strategic benchmark has a 5% allocation to Private Equity which I believe from a diversification, liquidity, risk and reward point of view is reasonable. However I believe that the Fund should consider investing in other Private Market asset classes and have a dedicated allocation to Infrastructure and Private Debt. As mentioned above these alternative asset classes have many of the attributes suitable for pension funds in that their returns are more highly linked to long term higher yielding contractual cash flows and provide diversified sources of income to traditional bond markets. While the manager selection process is resource intensive, Surrey will have these resources provided to it by its partnership with the BCPP Pool.

Further investment in the Private Equity and Infrastructure asset classes is merited, but because of the nature of the cash flows to and from the asset class and the growth of the Surrey Pension Fund, the level of investment will need to be monitored by the Pensions team, to ensure that the neutral weight is at least maintained so as to capture of the returns available. Until the Pensions and Investments Committee have a clear view of what Private Market funds the Border to Coast Pension Partnership has to offer and the timing of the delivery of this capability, the PIC will need to continue to make allocations directly to these alternative investment strategies. As mentioned above there is probably merit in having a dedicated allocation to Infrastructure and Private Debt.

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