

Surrey Pension Fund Committee

Private Markets Manager Review Meeting Minutes

November 2022

Attendees

Nick Harrison; Chair Pension Fund Committee (virtual)
Neil Mason; Assistant Director – LGPS Senior Officer
Lloyd Whitworth; Head Investment and Stewardship
Anthony Fletcher; Independent Adviser

Background

The purpose of this meeting was to receive an update from the selected Private Equity and Infrastructure Managers, Darwin Leisure and BCPP, on performance and activity over the last year for the Surrey Pension Fund.

To the extent these minutes contain the views of the adviser those views are intended as strategic advice to inform discussions around the strategic asset allocation. They are not intended as investment advice nor should they be relied on as such.

BCPP

Ian Sandiford; Head of Investment team (Alternatives)

Nick Livingstone; Portfolio Manager

Mandate summary

Surrey joined the BCPP private markets investment programme in April 2019, thus far Surrey have committed to Series 1 and 2. The total commitment to series 1 Private Equity was £150 million and £300 million to infrastructure, split equally over 3 tranches A, B and C. The commitment to private credit was slightly different, series 1A and 1B were combined with an instalment of £100 million a final instalment of £100 million to series 1C. The commitments have been phased in this way to ensure “vintage” diversification.

In April 2022 Surrey committed a further £485 million to the Series 2 investment round. Series 2A, consists of a further £50 million to Private Equity and £100 million each to Infrastructure and Private Credit. Surrey also committed £235 million to the series 2 Climate Opportunities Strategy.

The primary performance objective for Private Equity is 10% p.a. net of fees, the secondary PME benchmark is MSCI ACWI + 3%. BCPP will invest in a combination of strategies, characterised as Buyout, Special situations, Growth and Venture. The geographic split reflects the current market hence the largest weight is to the USA followed by Europe including the UK, Asia and the rest of the world.

The performance objective for Infrastructure is 8% p.a. net of fees. BCPP will invest in a combination of strategies, characterised as Core, Core + and Value-add / opportunistic. The geographic split also reflects the current market hence the largest weight is likely to be Europe including the UK followed by USA, Asia and the rest of the world.

The performance objective for Private Credit is 6% p.a. net of fees. BCPP will invest in a combination of strategies, predominantly Direct Lending, with smaller allocations to Real Assets, Mezzanine / Speciality and Opportunistic. The geographic split reflects the current market hence the largest weight is to the USA followed by Europe including the UK, Asia and the rest of the world.

The Climate Opportunities strategy is designed to exploit the opportunities provided by the transition to a lower carbon future. It will invest more broadly in operating assets, development assets and new technologies, including agriculture and forestry. Unlike the other strategies in the private markets series, this fund can invest in private equity, debt and infrastructure, and up to 10% in public listed investments. The regional exposure will most likely be dominated by North America and Europe including the UK, however between 0% and 30% could be invested in the rest of the world. The fund also has a longer commitment period of 3 years and its performance objective is 8% p.a. net.

Investments to date

Private Equity

BCPP has completed the commitment stage in its series 1 Private Equity General Partner (GP) selection process. The GP's have drawn 59% of series 1A capital and 40% and 18% of series 1B and 1C respectively, this is good progress over the last 12 months and slightly ahead of BCPP's projections.

As is the case with closed private market strategies, capital can be returned at any time on the realisation of investments or due to rebalancing on the receipt of new investor capital; to date 11% of series 1A deployed capital has already been returned to investors. Preliminary performance data to 30th June 2022, produced independently for BCPP for series 1A, suggests a preliminary IRR of over 40% (ranging between 5.4% and 68.4%) and a TVPI (Total Value to Paid In) of 1.6, (ranging between 1.1 and 2.7). It is far too early to draw any meaningful conclusions about series 1 performance at this stage because it is only 2 years since the start of the investment cycle.

Now that BCPP have completed the commitment stage, and appointed 24 different GP's, it is possible to

establish the likely sector and regional distribution of investments. At the sector level Buyout and Venture strategies are in the middle of the permitted range with Special Situations slightly below and Growth strategies slightly above the middle of the expected ranges. In terms of the expected regional distribution, BCPP found GP's offering more attractive opportunities in Europe and Asia than they did in the USA.

The Series 2A commitment phase began on 1st April 2022, at the end of September 48% of the committed capital had been allocated to 5 GP's, with another 2 in advanced due diligence, but at the time of writing none of this has been drawn. The only change in strategy between series 1 and 2 has been to reduce the maximum allocation to Buyout strategies from 80% to 70%. BCPP will be seeking new subscriptions to series 2B before mid-March 2023, the terms for series 2B are identical 2A.

Infrastructure

The series 1 Infrastructure commitment cycle to GP's has also been completed and GP's have increased drawdowns in the year to September. With 55% of series 1A, 33% and 45% of series 1B and 1C capital already drawn down respectively, this is well ahead of expectations.

Some of the Infrastructure strategies have also returned capital; to date 8% of series 1A and 5% of 1C, deployed capital has already been returned to investors. Preliminary performance data to 30th June 2022, produced independently for BCPP for series 1A, suggests an IRR of over 16% (ranging between -0.5% and >99%) and a TVPI of 1.2, (ranging between 1.0 and 2.0). It is far too early to draw any meaningful conclusions about series 1 performance at this stage at only 2 years since the start of the investment cycle.

BCPP have appointed 24 different GP's. At the sector level BCPP are around the middle of the expected range of deployment with slightly more Core+ and slightly less Core and Value Add strategies. In terms of the regional distribution, the GP's appointed are expecting to find more opportunities in the USA and fewer in Europe, Asia and the rest of the world relative to the mid-point of the expected regional range.

The Series 2A commitment phase also began on 1st April 2022, at the end of September 50% of the committed capital had been allocated to 4 GP's, but at the time of writing none of this has been drawn. The only change in strategy between series 1 and 2 is the regional allocation USA has been increased from 20-40% to 30-50% and Asia has been changed from 10-30% to 0-30%. BCPP will be seeking new subscriptions to series 2B before mid-March 2023, the terms for series 2B are identical 2A.

Private Credit

The series 1 Private Credit commitment cycle to GP's has also been completed and GP's have increased drawdowns in the year to September. With 51% of series 1A+B and 25% of series 1C capital already drawn down respectively, last year BCPP were slightly behind in terms of deployment but they have caught up and are now about 5% ahead of expectations.

Private Credit GP's have also returned about 5% of the capital from series 1 A+B. Very preliminary performance data to 30th June 2022, produced independently for BCPP for the whole series suggests an IRR of 20% and a probably more accurate TVPI of 1.1, (ranging between 1.1 and 1.2). It is far too early to draw any meaningful conclusions about series 1 performance as it so early in the investment cycle.

BCPP have appointed 12 different GP's. At the sector level the allocation is slightly ahead of the mid-range expected allocation for Direct lending and Mezzanine and slightly behind for Real assets and the Opportunistic debt categories. In terms of the regional distribution, the GP's appointed are finding more opportunities in the USA and Europe, fewer in Asia and at the moment none in the rest of the world relative to the mid-point of the expected regional range.

The Series 2A commitment phase also began on 1st April 2022, at the end of September 50% of the committed capital had been allocated to 2 GP's, but at the time of writing none of this has been drawn. Between series 1 and 2, the regional allocation to the USA has been increased from 30-70% to 40-80% and in Europe from 20-50% to 30-60%, Asia and the rest of the world are unchanged. BCPP have also changed the sector allocations 30-80% for Direct lending to 40-80% and Real assets from 0-50% to 20-50%. Subscriptions to series 2B need to be agreed before mid-March 2023, the terms for series 2B are identical 2A.

Climate Opportunities

Climate opportunities was not available in series 1 and came about due to Partner fund demand for investing in “Transition Alpha”. Partner funds wanted to be able to access not just operational renewable assets such as power generation but also the companies that were leading the development and rollout of new technologies that will be part of the transition of the “built economy” enabling a resilient and sustainable lower carbon future.

The commitment phase began on 1st April 2022, at the end of September 24% of the committed capital had been allocated to 3 GP’s, but at the time of writing none of this has been drawn. The regional allocation is expected to be 30-70% North America, 20-50% in Europe including the UK, 0-20% to Asia and 0-10% to the rest of the world. Sector allocations have been broadly set; 20-60% each for Operational and Developing Assets and a range of 10-30% in New Technologies. While this fund has a 3 year commitment period, compared to 2 years for the other private markets strategies, BCPP have suggested that deployment may be quicker due to a higher than expected supply of opportunities and even suggested they may be able to offer a second series sooner than expected.

Adviser view

It is too early at this stage to comment on the investment performance of any of the asset classes, but the longer running series 1A investments appear to have got off to a promising start given the economic conditions of the last two years. I am comfortable that BCPP has a robust process for GP selection and sufficient resources to help Surrey build and maintain an exposure to Private markets that is highly diversified by region, sector and vintage.

Part of the reason for pooling, was to give individual LGPS access to a wider range of asset classes, to improve the investment governance and due diligence band width and to save on fees. Thus far the decision to use BCPP for the investment of Surrey’s private market allocation appears to have achieved all of these objectives.

BCPP have estimated that they have achieved in aggregate, fee savings for Private Equity of 63bps or 32%, Infrastructure 34bps or 23%; Private Credit of 26bps or 22% and achieved estimated savings of 30ps or 18% for the climate opportunities fund. These fee savings are compared to the industry standard fee rates and not the fees that Surrey may have been able to negotiate on its own or as achieved in the past for some of its legacy investments. But the costs of BCPP completing GP discovery compare favourably with other methods of GP discovery, such as using an Adviser to do the search on behalf of Surrey or using a GP with Fund of Funds approach.

Pantheon Global Infrastructure Fund III

Andy Bush; Principal, Relationship Manager, Investor Relations Team
Jerome Duthu-Bengtson; Partner, Infrastructure Team
Welwin Lobo; Principal, Infrastructure Team
Tom King, Analyst, Investor Relations Team

Mandate summary

Surrey appointed Pantheon in 2018 to invest in an Infrastructure “fund of funds”; Pantheon Global Infrastructure Fund III (PGIF III). The committed capital was US\$ 60 Million. Pantheon will use a combination of secondary and co-investments as well as direct primary equity investments, to achieve full investment of the committed capital.

Investments to date

As of 30th June 2022, of the US\$ 60 million committed to Pantheon by Surrey, US\$ 44.3 million or 74% has been committed to investments. The NAV of Surrey’s investments is US\$ 47.6 million, and a further US\$ 8.7 million has been returned to Surrey via distributions on the disposal of assets. This means that on the invested capital the fund has delivered a net IRR of 11.9% or 1.27 times, multiple on invested capital (MOIC).

The fund is very well diversified owning 17 secondary investment funds and 20 co-investment funds, with a total of 199 different investee companies. By sector the largest allocation is digital infrastructure at 31%; 18% of which is invested in Fibre optic networks. Transportation 23%, which is evenly distributed between roads, ports, logistics and 3 airports, that represent around 7% of the NAV namely, London Luton, Gatwick and Melbourne, Australia. 19% is invested in renewable energy split between solar and wind, with the largest allocation (11%) in energy efficiency. In terms of geography 50% is invested in Europe, 38% in USA and 11% in Asia Pacific and the rest of the world. In terms of the type of fund, 56% is invested in secondary funds, 42% in co-investments and 2% is currently invested in primary deals.

Pantheon confidently expects to deploy over 90% of committed capital in the investment period. Indeed, Pantheon have drawn a further US\$ 11 million over the last year of which US\$ 6.6 million could have been funded from distributions. Over the next 12 months to the end of the investment period, Pantheon expected to draw a further US\$ 9.1 million and distribute US\$ 7.5 million. By the end of 2023, a little later than earlier forecast the fund will become a net distributor of cash with the majority of the capital returned over the following 4 years.

Adviser view

The fund’s investment strategy remains on track to deliver a portfolio of “core and core plus” investments with good diversification by sector. Distributions of US\$ 6.6 million in the last year an interim net IRR of 11.9% and an average net multiple of 1.27x as of 30th June 2022 are all reasonable and in line with expectations for this fund, and it is still in its investment period.

Despite my concerns around the launch of PGIF IV, Pantheon have not been distracted from continuing to deploy committed capital in PGIF III.

When quizzed about fees, Pantheon reminded us that Surrey pays an LGPS aggregate fee of 70bps, plus for secondaries manager fees are between 50 and 90bps, which they said was only about 2/3 the fee charged for primary deals and no manager fees are payable on 95% of the co-investments. But there are performance fees on top of these management charges. However, it does suggest that Surrey may need to do a more in depth analysis to see if on an “all in” basis BCPP’s claims to be a lower cost provider can be proven.

Glennmont Clean Energy Fund

Mandate summary

Glennmont Partners Fund III (GPF III) is a single strategy fund that invests directly in renewable infrastructure in Europe, the total fund size is Euro 850 million. Deployment of capital is expected to be 60% to 80% offshore and onshore wind, 15% to 25% solar with the balance in biomass electricity generation. Geographic distribution is targeted to be 20% each in UK and France, and 25% each in Germany and Italy, with the balance in other EU countries. Surrey have committed capital of Euro 45 million to this fund.

Investments to date

In December 2021 the fund reached full commitment to investment projects. The fund is well diversified by stage of development, geography and technology. The stage of development split is; operational assets 35%, assets under construction 56% and under development 6%. All projects are in the Euro-Area, by country Finland 17%, Germany 21%, Italy 17%, Portugal 7% and Spain 37%. This is a marked improvement from the much more Finnish and German geographic concentration reported last year, although Spain remains rather high. The mix of technologies has also improved with solar now the dominate source of production at 43%, onshore wind 34%, offshore wind 21%, and other 2%.

Adviser view

The management team have done a good job of identifying both good operational assets where they can use their asset management skills to create clusters of assets with a critical mass, and where this can't be achieved to divest assets at reasonable exit values. In terms of their construction and development assets, they have also identified good projects and have secured high quality clients to purchase the energy produced on guaranteed and inflation linked terms over the long term. The distribution of assets by geography and technology does not match the expected deployment at the outset, but it is probably better that Glennmont have focussed on the projects that can deliver the expected returns.

When quizzed about fees, Glennmont reminded us that Surrey negotiated an attractive level of management fees, but they were not able to provide details at the time. I have raised concerns about the overall level of fees accumulated by the GP and shown in it's report and accounts. Glennmont promised to report back with full details of the fees and charges that Surrey are paying and it is possible that these may be more favourable than the GP's accounts suggest.

Darwin Investments

Mandate summary

Surrey has three similar investments with Darwin. The Darwin Leisure Property Fund (DLPF) which dates back to 2013, initially Surrey invested £20 million in the “D accumulation” units. The second investment with Darwin is in the Darwin Leisure Development Fund (DLDF). Surrey invested £40 million in this fund and it is now fully drawn down and invested. The third investment was in 2021 where Surrey invested a further £25 million in the DLPF “K accumulation” units.

DLPF buys and operates leisure parks in the UK with a mixture of Camping, Touring caravan and Static holiday caravans / lodges. In this fund the approach has been to use the operational cash flow of the individual leisure parks to upgrade the leisure proposition to the holiday park and campsite sector. By offering better quality and more diverse leisure facilities that will attract an all year round usage, thereby increasing occupancy rates and annual turnover. The long term target return of DLPF is 6% to 8% p.a.

DLDF has a similar business model but this fund is focusing on locations that may or may not already have a “holiday park” offering. The locations need to have potential for re-development from their current use. The fund can use a modest level gearing to finance acquisition and re-development costs. The long term target return of DLDF is 10% to 14% p.a.

Performance update

Darwin Leisure Property Fund

In the 12 months to 30th September 2022 the return of the D accumulation units was 3.3% the same return as in the year to September 2021, over 5 years the fund has achieved 5.07% p.a. Surrey invested £20 million in 2013, the current NAV suggests an estimated value of £39,087,167.

On the 1st June 2021, Surrey invested a further £25 million in the K accumulation share class. At the end of September 2022, the NAV suggests an estimated value of £26,437,500. It is far too early to comment on the performance of this share class.

Darwin Leisure Development Fund

In the 12 months to 30th September 2022 the return of the B class accumulation units was 7.95%, which compares with 4.6% in the year to 30th September 2021. The total return over 5 years was 7.5% p.a. The estimated value of Surrey’s original investment of £40 million is £58.8 million.

Despite the upbeat commentary from Darwin, it is clear from the performance numbers that both funds have had a difficult period post covid. While bookings and occupancy rates are higher, increased costs due to generalised factors such as higher inflation and the difficulty recruiting and retaining staff have had an impact on returns in both funds.

Brexit and the perception of increased difficulty in travelling and the reduction in how long UK citizens can stay in the Euro-zone holiday destinations has increased interest in purchases of Lodges. This has also supported increased advance bookings for holiday accommodation in the UK, enabling operators to increase prices. These positive factors are expected by Darwin to go some way to offsetting the head winds of increased costs that are impacting profitability at least in the short term.

Adviser view

Over the medium to long term both funds have been an investment success in a niche area, with genuinely idiosyncratic sources of risk and return, but it looks as though returns maybe lower than hoped for by Darwin. Darwin has demonstrated skill in buying sites in good locations and then strong skills in asset management to evolve sites to a higher level of quality, occupancy and revenue by genuine innovation. They have also embraced the challenges of transition to a lower carbon future and are actively seeking to increase the positive contribution their businesses can make in the local economy where they operate.

Darwin was a little sketchy about total fees including any performance fees, but Surrey was able to negotiate quite low management charges. The AMC for DLDF B shares is 0.5% p.a.; DLPF D shares 0.8% p.a. and only 0.02% for DLPF K shares.

As with all private market funds there is an outperformance fee on top of the AMC, which is only paid above a certain hurdle rate of return. Darwin reminded us that their hurdle rate was 6% and that their share above it was 15% of the rate of return above 6%. For example, if they deliver 1% above 6% their share would be an additional 0.15%.

Because performance fees depend upon the level of outperformance and they are usually paid on exit, it is not always possible to know the total fees earned by the GP during the life of the fund, but an indication can be found in the report and accounts of the GP. Which is why negotiating hard with GP's at the outset on the AMC, the hurdle rate and the level of participation is so important. It is important that management teams are appropriately incentivised, but their level of remuneration must also be aligned with the total returns realised by the investor.



Anthony Fletcher – Independent Adviser to the Surrey Pension Fund

This document is directed only at the person(s) identified on the front cover of this document and is governed by the associated agreements we have with that person. No liability is admitted to any other user of this report and if you are not the named recipient you should not seek to rely upon it.

This document is issued by MJ Hudson Allenbridge a trading name MJ Hudson Investment Advisers Limited, an appointed representative of MJ Hudson Advisers Limited which is Authorised and Regulated by the Financial Conduct Authority. The Registered Office of MJ Hudson Advisers Limited is 1 Frederick's Place, London, United Kingdom, EC2R 8AE.



This page is intentionally left blank