

Surrey Pension Fund Committee

Private Markets Manager Review Meeting Minutes

November 2023

Attendees

Neil Mason; Assistant Director – LGPS Senior Officer
 Lloyd Whitworth; Head of Investment and Stewardship
 Anthony Fletcher; Independent Adviser

Background

The purpose of this meeting was to receive an update from the selected Private Equity, Infrastructure and Private Credit managers, 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.

Preface

The first part of my report covers the Private Markets investments we have with BCPP. These investments represent the post pooling future of how Surrey may seek to invest the majority of its private market's allocation.

The second part will cover the legacy investments Surrey has with various private markets managers. Most of these investments are at the end, or close to the end of their investment period and we should start to see increased realisations that will lead to net positive cash flows to the Surrey Pension Fund.

While it is important to understand how these assets are performing, we are not really in a position to change the allocation or sack one of these managers because of the contractual nature of the investment. It is possible to seek to sell, but in practice this is a very unpalatable experience which is very expensive and time consuming to achieve. It usually leads to the seller having to take a discount to NAV and not receiving a reasonable value on exit. This is also true of the private markets investments we make with BCPP; however, this allocation is still building and the pace of future commitments can be slowed to meet the asset allocation and cashflow needs of the whole Fund.

The reason I am reminding the committee of this, is over the last couple of years the overall value of assets has been stable and the growth rate of the Surrey Pension Fund has slowed. At the same time the cashflow dynamics of the Fund have been impacted by two larger than expected inflation increases to pensions in payment.

The Fund already has contractually committed to invest a total of £1,185 million into the BCPP private markets programme. Should the return of capital from legacy private markets investments slow, or if the value of the Surrey Pension Fund was to fall, or the cash flow dynamics of the whole Fund were to get worse. Then this level of commitments if called in full could distort the Fund's overall asset allocation and the Fund would have no choice but to respond by selling other more liquid assets like equities. This so called "denominator effect" had a significant impact on the asset allocation of closed corporate pension funds last year during the "Gilt Crisis" and continues to have an impact on their ability to manage their strategic asset allocation.

When the Fund is considering its future allocations to the BCPP private markets programme it may be prudent to think carefully about the commitments it has already made and the cashflow dynamics of the Fund.

BCPP

Ian Sandiford; Head of Investment team (Alternatives)
Jessica Wilson; Client Relationship 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 each series and to the Climate opportunities strategy is set out on table 1 below. The commitments have been phased in this way to ensure “vintage” diversification. Table 2 shows the percentage of the capital allocated by Surrey to each strategy has been invested.

Table 1, Private markets commitments to BCPP strategies in £ millions, September 2023.

Date of commitment	April 2019	April 2020	April 2021	Series 1 Total	April 2022	April 2023	Series 2 total	Total Commitments
Sleeve	1A	1B	1C		2A	2B		
Private Equity	50	50	50	150	50	20	70	220
Private Credit	100		100	200	100	30	130	330
Infrastructure	100	100	100	300	100		100	400
Climate Opportunities					235			235
Total Committed Capital across all private market strategies with BCPP								1,185

Table 2, Capital Allocated invested by and returned from Managers as a % of Commitments.

Private Equity %							
Commitments	99.7	99.1	100		99.8	45.8	
Invested	78.7	65.9	40.7		9.7	1.6	
Returned	17.5	2.0	0.1		0.0	0.0	

Private Credit %							
Commitments	99.5		99.5		100	23.7	
Invested	73.8		51.3		20.0	0.0	
Returned	14.6		7.8		0.6	0.0	

Infrastructure %							
Commitments	98.7	98.7	100		100		
Invested	72.8	53.4	76.1		31.3		
Returned	16.9	3.0	10.0		0.6		

Climate Opportunities %							
Commitments					71.9		
Invested					22.1		
Returned					0.5		

As of the end of September 2023, BCPP have allocated all of Surrey’s committed capital from Series 1 and Series 2A to their appointed Private Market asset managers, 71.9% of the capital available for Climate Opportunities has also been appointed. Thus far the 2B appointments are 23.7% to Private Credit and 45.8% Private Equity.

In money terms Surrey have committed £1,185 million to the BCPP private markets program over the 4 years

since it started of which, £533 million has been invested with various managers and £70 million has been realised and returned to Surrey. For asset allocation and cash flow management reasons Surrey reduced its allocations to series 2B, only adding £20million to Private Equity, £30million to Private Credit and no new money to Infrastructure. BCPP will be seeking new subscriptions to series 2C before mid-March 2024, the terms for series 2C are expected to be similar if not the same as those for series 2A&B. In addition, they will be launching and seeking subscriptions for a second Climate Opportunities fund and a new offering called UK Opportunities

The performance objectives, asset class sector and geographic distribution parameters for each investment strategy in series 1 and 2 were similar. The geographic split in all 3 strategies reflects the current investment universe hence the largest weight is to the USA followed by Europe including the UK then Asia and the rest of the world. For Private Equity the primary performance objective is 10% p.a. net of fees, with a secondary PME benchmark of MSCI ACWI + 3%. BCPP will invest in a combination of strategies, characterised as Buyout, Special situations, Growth and Venture. The performance objective for Infrastructure is 8% p.a. net of fees. BCPP will invest in a combination of strategies, characterised as Core, Core plus and Value-add / opportunistic. 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 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

In general, BCPP have managed to allocate capital across all 4 strategies at a reasonable pace. Private equity deployment has been somewhat slower than expected in Series 2, but the background for this appointment period has been difficult with the Russian invasion of Ukraine and the ramp up in Inflation, Interest rates and bond yields, significantly impact the flow of investment activity and realisations. Infrastructure, Private Credit and Climate Opps have all experienced deployment rates in line with expectations. About 60% of Surrey's Series 1 committed capital has been invested, while between 10% and 30% of the Series 2 capital has been invested.

Private Equity

Preliminary valuation data to 30th June 2023, produced independently for BCPP for series 1, suggests a net return of 15.2% (ranging between -4.9% and +40.8%) and a TVPI (Total Value to Paid In) of 1.2, (ranging between 0.94 and 2.3).

In series 1 BCPP appointed 25 different GP's. Asset allocation at the strategy level shows 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.

BCPP have managed to allocate 100% of series 2A capital to a total of 10 GP's, and for series 2B so far, they have only selected 3 GP's representing 45% of committed capital. The selected GP's in Series 2A&B have been slow to invest, with only 10% of series 2A capital invested and less than 2% of series 2B. In terms of the interim sector allocation, Buyout is at the upper range limit and Europe is at the top of the geographic range, with all other sectors and geographies at or near the bottom of their permitted range. This should be re-balanced as new GP commitments are allocated.

Infrastructure

Preliminary valuation data to 30th June 2023, for series 1, suggests a net return of 9% (ranging between -11% and +31%) and a TVPI of 1.1, (ranging between 0.85 and 2.3).

In Series 1 BCPP appointed 25 different GP's. At the sector level BCPP are around the middle of the expected range of deployment with slightly more Core plus 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.

The Series 2A appointment phase began on 1st April 2022, in total 9 GP's were appointed representing over 99% of Surreys commitment. Surrey decided not to commit any new capital to series 2B. The only change in strategy between series 1 and 2 is the regional allocation where the USA has been increased from 20-40% to 30-50% and Asia has been changed from 10-30% to 0-30%. At the moment with only 31% of committed capital invested, the aggregate series 2 allocation is at the top of its Core plus range and underweight in its allocation to Europe.

Private Credit

Private Credit GP's have returned about 22% of the capital from series 1, preliminary valuation data to 30th June 2023 for series 1 suggests a net return of 9.8% (with a range between 6.3% and 12.6%) and TVPI of 1.1, (ranging between 1.04 and 1.17).

BCPP appointed 12 different GP's for series 1, at the sector level the allocation to Direct lending and Mezzanine was slightly higher than target and slightly lower 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 the rest of the world.

The Series 2A appointment phase has been completed with the appointment of 4 GP's, who have thus far invested 20% of the money and returned 2.2%. BCPP have found 1 GP for Series 2B and so far, none of the money has been invested. In series 2, the regional allocation to the USA was 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%.

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 operationally 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 3 year commitment phase began on 1st April 2022 and has proceeded faster than expected, at the end of September 2023 BCPP have appointed 10 different GP's representing over 70% of the committed capital and 22% has been invested. In terms of asset mix BCPP have found Operating assets difficult to find at the right price but have now filled the allocation range for Development assets and are mid-range in New Technologies. Regionally the fund currently has a higher allocation to opportunities located in Europe.

BCPP have found that the pipeline of opportunities that are aligned with the Climate Ops strategy has been greater than expected and as a result they have decided to launch a second fund, for which they will be seeking subscriptions before mid-March 2024, the terms for the new fund are likely to be similar to the current offering.

UK Opportunities

In order to help partner funds with commitments to delivering impact in the UK and to accommodate the request from Government for LGPS Funds to consider supporting sustainable, long term development in the UK. BCPP have designed the UK opportunities fund. As the name suggests it will invest solely in the UK and predominantly in investments that will deliver an appropriate risk adjusted return but also deliver measured environmental and /or social impact at the same time. The total return target will be 8% net p.a. and the fund size will be capped at £1 billion. While there will be no regional allocation limits, the fund will have the ambition, but not a commitment to invest some capital within the “BCPP region”, however for risk adjusted return and diversification reasons invest within region is not guaranteed. The graphic below gives an idea of the areas of investment the UK Opportunities fund could seek to exploit.

TARGET STRATEGIES

UK Opportunities could deliver investment in the following strategies:



Border to Coast. Surrey Alternatives, Nov 2023

Adviser view

It is too early at this stage to have any investment performance for series 2 and the Climate Ops strategy. The longer running series 1A&B investments appear to have got off to a promising start given the economic conditions of the last three years. The independent valuations of investments in series 1 shows a wide range of outcomes but in aggregate they appear to be broadly in-line with return expectations at launch. 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 these objectives. On fees, BCPP have estimated that they have achieved in aggregate, fee savings for all their private markets strategies. However, 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 has achieved in the past for some of its legacy investments. Having said that, it is better to focus on the returns that are achieved and then to judge whether Surrey has achieved long term “value for money” from the BCPP private markets investment programme.

Goldman Sachs Asset Management

Mandate summary

Surrey has a very long relationship with GSAM private equity, which started in 2000. Over that time Surrey has invested in 7 different vintage year, Private equity fund of funds, 5 of which have invested in Primary offerings and 2 in Secondary offerings. The last investment was in West Street Infrastructure Partners fund III, which is being managed by Goldman Sachs Merchant Bank. This report covers the 5 remaining investment vehicles in which Surrey has an investment.

Investments - Private Equity

All of the funds have come to the end of their investment phase and are now returning capital. Fund performance has been mixed, as would be expected due to the vintage year. The lowest return on capital invested was achieved by PEP 2004 which delivered 1.5x TVPC and a very low IRR, fortunately, Surrey only committed US\$ 10 million to this fund. The secondary market funds, Vintages VI and VII have done rather better, Goldmans reported that as of 30th June 2023 the net ROI was 1.63x and 1.84x, with net IRR's of 12.1% and 14.9% respectively. The final private equity primaries fund investment was made in 2011, PEP XI, this fund has delivered a net ROI of 2.2x and net IRR of 18%.

Adviser view - Private Equity

In aggregate the investment in private equity with GSAM has been made using a highly diversified fund of fund strategy. The variation in the IRR shows the importance of vintage diversification. It can take a long time to get invested and harvest returns therefore the timing of entry and exit from closed end fund structures can be significantly impacted by the business and economic cycle, which will impact the total return.

While average returns have outperformed the Public Market Equivalent (PME) these legacy investments are an expensive route to market with several layers of high fees and charges not just for GSAM but also the underlying fund managers. Surrey is already benefitting from the more cost efficient route to market provided by BCPP, where fees may be lower and probably with an equally robust investment process.

Investments - Infrastructure

West Street Infrastructure Partners (WSIP) fund III, the fund's objective was to invest in a global portfolio of infrastructure investments in a wide range of sectors, where companies have sector expertise and enjoy high barriers to entry for competitors. In total the fund made 10 different investments between January 2016 and December 2020, the fund is now in the process of selling its investments and returning capital to investors. As of the end of June 2023, the fund has sold completely three companies in the US and one partially in Europe. The valuation shows that the net ROI is 1.5x and the net IRR is 9% but this is dependent on reasonable exits from the 6 remaining investments.

Adviser view - Infrastructure

WSIP III is a single fund with a small number of high commitment investments, similar to the Capital Dynamics infrastructure fund, but completely different to the Pantheon Infrastructure, fund of funds approach. As it turns out West Street's due diligence process and a conservative valuation policy, appears to have delivered a better outcome for its investors than Capital Dynamics at this stage. But it should be noted that Pantheon's approach has actually delivered a better net return (see below).

As I mentioned before I believe BCPP should be able to give Surrey cheaper access to this type of infrastructure strategy

Pantheon Global Infrastructure Fund III

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 have mainly used secondary market investments, co-investments and a few primary market investments, to achieve full investment of the committed capital.

Investments to date

As of 30th June 2023, of the US\$ 60 million committed to Pantheon by Surrey, US\$ 53.3 million or 89% has been committed to investments. The NAV of Surrey’s investments is US\$ 54.5 million, and a further US\$ 16.2 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 11.5% or 1.33 times, multiple on invested capital (MOIC).

The fund is very well diversified with 56% invested in secondary investment funds and 42% in co-investment funds, with a total of 199 different investee companies. By sector the largest allocation is digital infrastructure at 31%. Transportation 23%, which is evenly distributed between roads, ports, logistics and airports. 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.

Pantheon confidently expects to deploy over 90% of committed capital in the investment period. In the last year US\$ 9 million was drawn and US\$ 7.5 million distributed. In the last 12 months to the investment period, Pantheon expect to draw a final US\$ 3.7 million and distribute US\$ 15.6 million. By June 2024 a little later than originally forecast the fund will become a pure 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\$ 7.5 million in the last year an interim net IRR of 11.5% and an average net multiple of 1.33x as of 30th June 2023 are all reasonable and in line with expectations for this fund, as it comes to the end of its investment period.

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 of 10% over the hurdle rate of 8% are on top of these management charges. From year 7 the funds fees will taper lower. Pantheon, have a very good ESG service delivery and promised to have the funds ESG metrics available for Surrey’s TCFD report. When asked about the contribution to performance from ESG, they noted that the portfolio companies’ de-risk via ESG, but it was not clear that more money was being made by a focus on ESG.

Capital Dynamics

Mandate summary

Surrey has invested into four funds with Capital Dynamics; £8 million each into 3 private equity funds specifically designed for LGPS investors and one infrastructure fund. The private equity funds have a fund of funds structure but with a very low manager selection fee of 0.05% (the fee paid to Capital Dynamics). Surrey's private equity investments have different vintages; 2016/17, 2017/18 and 2018/19. Another feature of the private equity funds is their structure. In order to mitigate the negative performance that can be experienced with many primary only funds, during the investment period (the "J" curve effect). The funds can buy up to 30% of their investments from the secondary market, thereby receiving some distributions immediately, rather than having to wait for distributions from their primary market investments. Surrey has also invested US\$25 million into their Clean Energy and Infrastructure Feeder Fund, which invests in renewable energy generation, distribution and storage.

Performance update

Based on the valuations of the funds on 30th June 2023, the net returns are as follows.

Capital Dynamics Funds	Total value / paid in capital	% IRR net
LGPS Private Equity 2016/17	1.7x	15.6
LGPS Private Equity 2017/18	1.6x	18.2
LGPS Private Equity 2018/19	1.4x	20.2
Clean Energy and Infrastructure 2013	0.6x	-5.3

The performance of the private equity funds has been good; across all 3 vintages, the purchase of secondaries has completely mitigated the "J" curve effect with distributions being received from the start. Vintage 2016/17 has drawn down 80%, vintage 2017/18 has drawn 89% and vintage 2018/19 has drawn 71% of Surrey's committed capital. The Clean Energy Infrastructure fund has invested 97% of Surrey's capital.

Investments to date

Private Equity: Each of the private equity funds invests in a wide range of GPs in various geographies with different skill sets in various parts of the market, including special situations, buyout, growth and venture. These GPs then invest into a large number of companies to achieve a diversified portfolio in order to mitigate the risk. As a result, each Capital Dynamics fund could hold over a 1000 different investee companies. The returns shown above demonstrate the value of this diversification, with strong returns against a backdrop of Covid, the Russian invasion of Ukraine and changes in regulations in China. Capital Dynamics reported that CMC capital, one of its GP's in the 16/17 vintage fund has significant exposure to China and they have marked down the value of these investments. They also reported that some of the Investments in vintage 17/18 based in the UK were struggling against a background of higher interest rates, but that these poorer valuations were already reflected in the June 2023 valuation. At the moment there were no impairments to report in the 2018/19 vintage fund.

Infrastructure: The situation, that seemed to be under control in the Clean Energy infrastructure fund has gone from bad to worse. The development, asset management and outlook for the two Texas based wind farms has become significantly worse. One wind farm has experiencing very bad performance with its turbines, which means it has been unable to deliver the contracted supply of electricity. The other is experiencing very poor connectivity to the electricity grid infrastructure and both facilities were negatively impacted by the severe weather events that Texas has experienced in recent years. Capital Dynamics were able to confirm that remedial works were in progress which may recover some of the costs of the projects and that the funds liability had a floor at zero. As a result, this fund is highly unlikely to achieve its target returns despite the relatively good performance of the other investments in the fund.

Adviser view

The Private equity funds provided by Capital Dynamics have delivered very good returns for Surrey, but the performance of the infrastructure fund shows the importance of diversification. The highly diversified nature of the private equity, fund of funds approach, means that Surrey's direct exposure to individual investments is low. Provided there is no systemic event or over concentration in a sector or geography, investment risk can be mitigated. Infrastructure on the other hand, tends to have fewer and much bigger investments, where if one investment goes wrong it can have a significant impact on a portfolio even if the rest of the investments deliver on their expected returns.

While it is Surrey's long term objective to invest more in BCPP over time, should their private equity not deliver the desired performance, Capital Dynamics may on the experience to date, offer an alternative. Their manager selection fees are conquerable to BCPP as are their strong ESG credentials.

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. At inception the 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.

Performance update

Based on the valuation of the fund on 30th June 2023, the fund has a net IRR of 6.54% and a TVPI of 1.12x. The distribution yield is running at 7%, higher than expected.

Investments to date

The fund is now fully invested and has delivered its first sale, a wind farm at Goudelancourt in northern France. With the investment phase completed the shape of the actual portfolio of assets can be seen, it is slightly different to expectations at launch but not materially. 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%. Solar is the dominant source of generation at 43%, onshore wind 34%, offshore wind 21%, and other 2%.

To support the ongoing development and exits from the other projects in the fund Glennmont have increased the size of these teams. They have also appointed PWC and Ernst & Young as valuers to start the process of price discovery. The modelling will use 31st December 2023 as the "valuation date" using the prevailing interest rates and power price forecasts at that time to calculate the NAV. They have outlined a hierarchy of sales but this will be flexible and dependent on the current phase of development and the attractiveness of the bids they receive.

Over the last 18 months, with 56% of the fund in its construction phase, higher costs, have had an impact on profitability. Weaker energy prices, higher interest rates and reduced government support has also depressed valuations. Glenmont pointed out that the price of most of their generation capacity has been contractually agreed and while some of the prices are capped, they are aligned to inflation which will increase the value of future revenues. Glenmont reminded us that the strategy of the fund was to buy and develop clusters of generating assets that have sufficient size that could then be sold on to other investors who want to benefit from a long term inflation aligned cash flow, with low operational and maintenance costs. They expect the range of buyers to be quite diverse including utilities and manufacturers who are looking to replace legacy high carbon generation, Sovereign Wealth and Pension funds for the inflation aligned cash flows, energy distribution companies and even Oil companies, who are emerging as a buyer in order to diversify their businesses.

Adviser view

The management team have done a good job of identifying good locations where they can increase scale to create clusters of operational and development assets with a greater critical mass, and where this can't be achieved to divest assets at reasonable exit values. The past 18 months has been a very difficult period with higher construction costs and increased interest rates having a significant short term impact. However, the inflation aligned nature of the revenues should mitigate this impact over the longer term. From here forward Glenmont will need to focus on getting the full value from the sales of their investments if they are going to deliver the target return. I believe this is going to be more difficult and may take longer than expected in the new environment of "normal" interest rates.

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.

Valuation update

Both funds are valued using a 10 year Discounted Cash Flow methodology, a bit like the method used to estimate future liabilities of pension funds. But unlike a pension fund, where this model is used to estimate the present value of future liabilities, and that results in a decreased liability value as interest rates rise. The impact is the other way round when applied to Assets, e.g. the present value of the leisure parks accommodation units and the value of future rental income from those units, falls when interest rates rise.

Darwin uses an independent valuer to determine the appropriate discount rate that is used to appraise the value

of assets. At the Board meeting in July 2023, the Boards of both funds accepted that because interest rates had risen significantly over the previous 2 years and that it was more likely that they would remain high for some time, it would be prudent to accept the valuers higher discount rate and the impact that would have on the present value of the assets in each fund.

This has resulted in significant fall in the value of both funds and this revaluation is responsible for the very poor 12 month performance of the funds reported below.

Performance update

Darwin Leisure Property Fund

In the 12 months to 31st October 2023 the return of the D accumulation units was -30.8%, this write-down is so significant that it has had a marked impact on the longer term returns. Over 5 years the D Shares have now returned -3.8% p.a. however, over 10 year the annualised return is +3.2%.

On the 1st June 2021, Surrey invested a further £25 million in the K accumulation share class. At the end of October 2023, the 12 month performance was -30.3%, which is decline in value of -26.3% since June 2021.

Darwin Leisure Development Fund

In the 12 months to 31st October 2023 the return of the B class accumulation units was -14.8%. The total return over 5 years remains positive but has fallen to +2.5% p.a.

Strategy and Fund update

Darwin remains upbeat on the businesses as an “on-going concern”, on the positive side for both funds, occupancy rates and future bookings for rentals remain high. Customer Satisfaction surveys are very positive and both businesses having received a number of Industry awards for quality and service provision. Initiatives to reduce operating costs are expected to improve profitability, including a 2 year fixed price contract for cleaning accommodation units. On the revenue side they have been able to pass on higher costs through higher rental charges and they have increased flexibility of booking periods to increase occupancy and allowed more units to become “pet friendly” which also increases net revenue.

Specifically, for the DLPF revenues are higher as maintenance work at a couple of sites has been completed and sales of lodges which had slowed to zero are now being achieved. In the DLDF a number of re-developments, most notably the high quality Blenheim Palace lodge retreat and the Plas Isaf site in North Wales, have opened for business. Other development projects are also proceeding as planned.

From an operating point of view this is all good news for the businesses as an “on-going concern” and will help Darwin work through the impact of the write down arising from the change in weighted average cost of capital, provided they do not have to sell any assets in order to keep the business going. While there is some leverage in both funds it appears to be in-sufficient to have triggered any Bank funding covenants.

However, the DLPF does have an additional challenge to manage. One of their larger Private Wealth managers has, due to a change of ownership, decided to sell its holding in the fund. In order to manage this liquidation without impacting the remaining investors, Darwin have set up what is referred to as a “side car” portfolio that will hold sufficient assets, that once sold, will meet the redemption requirements. Darwin have already used on balance sheet cash and borrowings from a revolving credit facility to part fund the redemption. However, it will require the sale of some assets, which they view as non-core to the long term running of the business. They have also launched a capital raise where they will issue new “K shares” to new and or existing investors, to help with the process.

Adviser view

I mentioned last year that Darwin was struggling to recover from the impact of Covid on their business model. An extended period of closure for which they were only partly compensated for by government support, the problem with returning, recruitment and retention of staff and higher costs due to inflation and supply side disruption.

The evidence they provided in this and last year's report, on occupancy, customer satisfaction, cost reduction measures and increased revenues, provides support for their optimism that the funds are likely to be able to recover from that period of poor performance and deliver the targeted long-term returns. However, the NAV revaluation and the decision of a major investor to sell their holdings has made that investment performance recovery more difficult to achieve.

I do not believe Surrey should consider seeking to sell this investment at this stage, as this could only be achieved at a significant discount to an already reduced NAV. However, Surrey will need to pay close attention to the ongoing revenues and profitability of the businesses in both funds, so that while we will have to accept a lower level of return in the short term, we may have the reasonable expectation of better performance in the long term. In addition, for DLPPF, the result of the capital raise and the sale of assets to meet the redemption are important considerations, in order to make sure as an ongoing investor Surrey are not dis-advantaged.



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 Apex Investment Advisers Limited (no. 4533331) is a limited company registered in England & Wales. Registered Office: 6th Floor, 125 London Wall, London, EC2Y 5AS. Apex Investment Advisers Limited (FRN 539747) is an Appointed Representatives of Khepri Advisers Limited (FRN 692447) which is Authorised and Regulated by the Financial Conduct Authority.

This page is intentionally left blank