DF/23/32
Investment and Pension Fund Committee
3 March 2023

PRIVATE MARKETS INVESTMENTS

Report of the Director of Finance and Public Value

Please note that the following recommendations are subject to consideration and determination by the Committee before taking effect.

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1) Recommendation

That the Committee be asked to:

(a) Note the progress being made on the investment of the Fund's private markets commitment.
(b) Agree that no top-ups be made to Brunel's existing Cycle 3 Infrastructure, Private Debt and Private Equity portfolios.
(c) Authorise officers to engage further with Brunel on the potential options for a local impact fund to be funded from the Fund's private markets allocation.

2) Introduction

2.1 Private markets comprise investments not traded on a public exchange or market. They are an important part of the Devon Pension Fund's portfolio as:

- They are expected to generate higher returns as a result of the illiquidity premium available to producers of long-term capital.
- They provide diversification of returns.
- They provide access to investment opportunities not usually accessible through public markets.
- They provide greater potential for outperformance through active, hands-on management.
- Infrastructure assets in particular can provide inflation linked returns that will assist the Fund in managing inflation risks.

2.2 The Fund's Investment Strategy Statement shows a medium-term target allocation to private markets of 30%. This includes a longstanding 10% allocation to Property, which is not addressed by this report, except in relation to local investment.

2.3 The nature of private markets means that it can take time to build up investments to the desired level, as commitments need to be made to suitable funds, which are then drawn down as the funds identify suitable assets to purchase. Brunel's infrastructure, private debt and private equity portfolios operate on the basis of a two-year cycle, and client funds are required to make commitments at the beginning of each two-year cycle, with the opportunity to “top-up” their commitment one year later. No additional commitments are permitted between these dates. Cycle 1 was launched in 2018, cycle 2 in 2020 and cycle 3 in 2022. During March there is the opportunity to top-up allocations to cycle 3 if required.

2.4 The current progress towards achieving the target allocations is summarised in the following table.

Private Markets Allocations

Asset Class	Medium Term Target Allocation	2022/23 Target Allocation	Current Allocation as at 31 Dec 2022
Infrastructure	10%	8%	8.7%
Private Debt	5%	3%	2.9%
Private Equity	5%	3%	0.8%

2.5 The proportion of the Fund allocated to private markets has grown during 2022/23, as more capital has been called, but also because the assets have continued to show positive returns while the value of other asset classes has fallen. Based on the current Fund value of £5.13 billion, a 10% allocation to Infrastructure would equate to around £510 million and a 5% allocation to each of Private Debt and Private Equity would be around £255 million. However, the cycle 3 commitments were agreed based on the December 2021 Fund valuation, which was nearer £5.6 billion, so the target allocations were higher. Despite good progress in commitments being drawn, allocations still remain short of the medium-term targets.

2.6 This report provides the Committee with further details on the individual private market portfolios and the current position on the commitments made. It also looks at how the private markets allocation could support the UK Government’s levelling-up agenda, including the potential for local investment.

3) Infrastructure

3.1 Infrastructure funds are long term funds, typically with a life of 15-20 years. Before the set-up of Brunel, the Devon Fund had invested in five infrastructure funds, and will remain invested in those funds until they reach the end of their fund lives and have sold off all their assets. In addition, the Fund committed £175 million to Brunel’s first infrastructure cycle, £310 million to Brunel’s second infrastructure cycle, and £100 million to Brunel’s third infrastructure cycle. The Devon Fund’s total current commitments are set out in the following table.

Infrastructure Commitments as at 31 December 2022

	Total Commitment[1] £'000	Current Valuation £'000	Remaining Commitment £'000
Pre-Brunel Investments			
Archmore (UBS) IIF[2]	38,375	12,962	-
Igneo European DIF[2]	42,915	29,771	-
Hermes IF	47,275	47,881	10,000
Aviva IIF	40,000	28,149	8,493
Aviva Ground Rents Fund	20,000	16,932	-
	188,564	135,695	18,493
Brunel Infrastructure Portfolio			
Capital Dynamics CEI VIII	20,000	15,072	5,900
Capital Dynamics CEI VII-A	13,060	13,057	865
Vauban CIF II	9,870	12,011	251
NTR	8,454	8,137	1,224
Stepstone Brunel Fund I	122,942	90,255	40,780
Stepstone Brunel Fund II General	155,000	102,919	56,197
Stepstone Brunel Fund II Renewables	155,000	63,885	96,607
Stepstone Brunel Fund III	100,000	4,968	94,859
	584,327	310,304	296,683
TOTAL	772,891	445,999	315,176

Notes
1. Where the Fund is denominated in another currency, figures are based on foreign exchange rates as at 31 December 2022.
2. Investment period has ended, therefore no further commitment will be drawn.

3.2 Of the five pre-Brunel funds, the Archmore Fund managed by UBS and the Igneo Fund are both due to be closed by 2024 and have already returned a significant proportion of the capital invested. We can therefore expect to see the remaining £44 million returned to the Fund over the next two years. Additional commitments to the Hermes and Aviva Infrastructure Funds have been agreed over the last two years as a result of the restructuring of those two funds and the new commitments have yet to be fully drawn.

3.3 Given the time it takes for commitments to be invested, and the likelihood that the full committed amount may never be drawn down, it is necessary to over-commit by 20-30% in order to achieve the desired allocation. It will also be necessary to re-invest capital returned in order to maintain the investment at the appropriate level.

3.4 The current level of invested capital plus the outstanding undrawn commitments should be sufficient to achieve the 10% target, even given the need to reinvest the capital to be returned by the Archmore and Igneo funds. It is not therefore proposed to top up the allocation to cycle 3, but an alternative option is considered in Part II of the agenda.

4) Private Debt

4.1 Private debt is a broad term that refers to any investment in privately negotiated debt. Borrowers often choose private financing because it can be customised to their needs or when public debt is not available. Private debt funds focus on direct lending to private companies, providing an attractive opportunity with a shorter investment term than infrastructure investments and a regular yield. The Devon Fund's current investments and undrawn commitments are shown in the following table.

Private Debt Commitments as at 31 December 2022

	Total Commitment[1] £'000	Current Valuation £'000	Remaining Commitment £'000
Pre-Brunel Investments			
Arcmont Senior Debt Fund I[2]	90,000	36,074	-
Golub Capital International Fund 11[2]	60,464	54,556	-
	150,464	90,630	-
Brunel Private Debt Portfolio - Cycle 2			
Aksia Brunel Private Debt Fund (Cycle 2)	100,000	48,604	64,070
Brunel Private Debt Portfolio - Cycle 3			
BlackRock European Private Debt Fund III	35,470	11,790	23,680
Uncommitted by Brunel	144,530	-	144,530
	180,000	11,790	168,210
TOTAL	430,464	151,024	232,280

Notes
1. Where the Fund is denominated in another currency, figures are based on foreign exchange rates as at 31 December 2022.
2. Investment period has ended, therefore no further commitment will be drawn.

4.2 The Arcmont Fund is due to close in the next two years and is expected to return all capital by the end of 2024. The Golub Fund still has five years left to run, but is unlikely to draw more capital, hence a zero remaining commitment is shown.

4.3 After a slow start Brunel's cycle 2 is now making good progress in committing and investing the allocation made to them, and cycle 3 has begun to draw capital.

4.4 A 5% commitment would equate to an investment of around £255 million, based on the total value of the Devon Fund. The current value of the investment in private debt is still some way short of this, but significant commitments remain to be invested. As with infrastructure, it is prudent to over-commit in order to achieve the desired level of investment. The capital to be returned by Arcmont will also need to be reinvested.

4.5 However, the significant commitments that remain to be drawn should in time take us up to the target allocation. It is not proposed to top-up the commitment to the cycle 3 portfolio, but to review the situation when cycle 4 is launched next year.

5) Private Equity

5.1 Private equity is a broad term that refers to any investment in privately owned equity i.e. not listed on a public exchange. Typical investments include venture capital to new or growing businesses and buyouts with the intention of turning the company around. These can be very attractive investments, often producing higher returns than listed equity, and also producing an income yield that is attractive to mature funds such as the Devon Fund who need cashflow to meet pension payments.

5.2 The Devon Fund made its first commitment and investment in private equity through Brunel's cycle 2 portfolio, committing £125 million, with a further £150 million committed to cycle 3. The current position and the underlying funds that Brunel have committed to and invested in are shown in the following table.

Private Equity Commitments as at 31 December 2022

	Total Commitment[1] £'000	Current Valuation £'000	Remaining Commitment £'000
Brunel Private Equity Portfolio (Cycle 2)			
LGT Crown Global Secondaries	16,253	8,281	10,451
AlpInvest CoInvestment Fund VIII	20,316	9,944	10,698
Montana ("MCP") Opportunity Secondaries	8,652	3,298	6,111
New Mountain Capital Partners VI	8,126	4,315	4,072
Insight Partners XII	7,885	4,515	2,677
Insight Partners X Follow-on Fund	7,885	5,461	1,573
Genstar X (Europe)	5,692	3,029	2,843
Genstar X Opportunities	1,629	1,016	678
Inflexion Buyout Fund VI	6,304	223	6,198
Summa Equity Fund III	7,885	(241)	7,845
J-Star No.5	6,432	-	6,378
PAI Partners 08	11,750	-	11,750
Atomico Venture 06	7,885	141	7,586
Baring Asia 08	10,247	-	10,247
Apax Global Impact	14,721	(160)	14,721
	141,662	39,822	103,828
Brunel Private Equity Portfolio (Cycle 3)			
Uncommitted (by Brunel)	150,000		150,000
TOTAL	291,662	39,822	253,828

1. Where the Fund is denominated in another currency, figures are based on foreign exchange rates as at 31 December 2022.

5.3 While Devon committed £125 million to cycle 2, the current value of the commitment made by Brunel on behalf of Devon stands at £141.7 million. This results from the commitments made in US Dollars, where the increased value of the US Dollar against Sterling has inflated the value of the commitments made above the original commitment figure.

5.4 Given the need to over-commit, the current level of commitment is insufficient to reach the target allocation of 5% of the Fund. However, a key risk with private equity investments is vintage risk. This is the risk that if the investment is made at the wrong point in the economic cycle, then it may not achieve the desired outcome. Therefore, private equity investments should be spread over different vintage years in order to diversify the risk. The strategy is therefore to build up the commitment gradually in order to manage vintage risk.

5.5 It is not, therefore, proposed to top up the allocation to cycle 3, but to wait until cycle 4 is launched in 2024 and make a further commitment to private equity at that stage.

6) Levelling Up and Local Investment

6.1 When the Government published its Levelling Up white paper in February 2022 it included a proposal to require LGPS pension funds to put in place plans to show how they would invest up to 5% of their fund in local investments in support of the levelling up agenda. Further details of this are expected via a consultation and ultimately revised statutory guidance or regulation, however it is understood that the Government defines "local" in this context as meaning within the United Kingdom.

6.2 We have always been wary of making local (i.e. Devon / wider South West) investments due to the potential conflict of interests. The Pension Fund would need to be sure that local political priorities did not over-ride the fiduciary duty to provide the returns required to meet the funding strategy. This could particularly be a problem if an investment was seen as failing from a financial point of view but was providing a key local service. However, other LGPS funds have found ways of making local investments whilst managing the potential conflicts and ensuring that their return expectations are met at an appropriate level of risk.

6.3 Recently, the Cornwall Fund has worked with Brunel to set up a bespoke Cornwall Local Impact Fund. The specification for the portfolio is attached at Appendix 1 to this report. The potential conflict of interest is managed by utilising two fund managers employed by Brunel in other portfolios. Brunel invest in the PGIM (Prudential Global Investment Management) UK Affordable Housing Fund through the UK Property portfolio. Where PGIM find an opportunity to invest in affordable housing in Cornwall which they will invest in through their main fund, they will then look to make an additional investment for the Cornwall Local Impact portfolio. Only investments that qualify for investment through the main fund would be agreed for the Cornwall fund. A similar arrangement exists with Greencoat who manage a renewable energy fund in which the Brunel Secured Income portfolio is invested.

6.4 If the Devon Fund wished to invest in a similar local impact portfolio for Devon, then the investment would need to be part of the Fund's private markets allocation. We could choose to set up the new portfolio in preference to making commitments to the Brunel cycle 4 portfolios when they are launched next year. This would enable us to keep within our current 30% strategic allocation to private markets.

6.5 Officers' view on this is that the Cornwall return target of 5% is a little low, given the level of risk involved and given that it would be an alternative to current infrastructure investments which target a higher return. This could perhaps be addressed by diversifying the fund further by adding other forms of local infrastructure such as broadband or meeting local infrastructure requirements of new developments, as presented by Gresham at the November training day.

7) Conclusion

7.1 The Committee is asked to note the progress being made in deploying the capital previously committed to the private market portfolios. Given the significant cycle 3 commitments made a year ago, it is not proposed to top up any of the private market cycle 3 portfolios in the current window. A separate infrastructure opportunity is set out in Part II on the agenda.

7.2 Private market allocations will be reviewed again at this time next year, when Brunel launch their cycle 4 portfolios. In the meantime, the Committee is asked to authorise officers to investigate the options for a local impact fund, which could provide an alternative means of increasing the Fund's private market investment to making significant commitments to cycle 4.

Angie Sinclair
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Electoral Divisions: All

Local Government Act 1972: List of background papers

Nil

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Appendix 1

Cornwall Local Impact Portfolio

Portfolio Objective	To provide exposure to a portfolio of local impact investments, generating long term returns, from a mix of income and capital appreciation.
Performance Target (net)	Net 5.0% p.a. IRR over a rolling 7 – 10 year period.
Benchmark	n/a – absolute return target.
Investment Strategy and key drivers	The Portfolio will provide exposure to impact investments, both social and environmental, with a majority located in Cornwall. The portfolio will comprise affordable housing in Cornwall with the remainder invested into renewable energy in both Cornwall and UK-wide. Political, economic, technological and operating risk exposures are unavoidable and required to achieve the targeted impact and returns. Leverage may be used at the Manager's discretion. Controlled construction risk is intrinsic to delivering this Portfolio, facilitating investment in new build ("greenfield") projects. Very limited currency risk is present in the Liquid Investment Portfolio in the early years, but long-term the majority of investments will be GBP denominated.
Risk/Volatility	Absolute risk/volatility: **Medium to High**. Positive but low correlation to other asset classes. Positive correlation to economic factors, commodity prices, bond markets and discount rates. The illiquid nature of the investments may create an illusion of lower short-term volatility, but values can be subject to significant moves over the medium term. Political risk is unavoidable and prevalent, given the fixed asset, concentrated nature of the target investment universe. Climate risk is present, both physical and transitional. Construction risks are present. Reputational risks may be elevated, given the local nature of the investments and their nature, especially in the provision of shelter. Concentration risks of limited sub-sector and geographic diversification; Portfolio is purposefully targeted at specific asset types. Relative/Active risk: **Medium**. Manager skill can vary, and the various market sectors perform differently.
Liquidity	Illiquid. Investments will be fundamentally illiquid in nature. There may be a secondary market for some of the assets in the portfolio at points in time, but realisations may be slow or at significant discounts.
Income	The Portfolio will target capital appreciation and income generation to achieve the target IRR. Any income generated will take time to be distributed for assets being constructed. Yield may therefore be lower in the early years and even once paid, may be recallable for certain purposes by the fund. Income will be in GBP £.
Investment Styles	Concentrated; the Portfolio will be invested into 3 funds only, the sizes of which vary considerably; 2 funds are dedicated to Cornwall and therefore limited by the size of CPF's committed capital. The third fund is a large diversifier that will provide (once drawn) initial yield and a seed asset portfolio. Once fully invested, the portfolio will have a sufficient number of

	investments, but their nature is concentrated by sector and geography. This has been discussed and agreed with the Client, based on the suitability requirements of the Portfolio.
Responsible Investment	Managers will have high ESG standards, having been selected to deliver measurable impact.
Reporting	In accordance with the Reporting and Monitoring Framework.