DFP/24/30
Investment and Pension Fund Committee
1 March 2024

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 allocation be made to Brunel's Cycle 4 Infrastructure and Private Debt portfolios.
(c) Approve a £100 million allocation to Brunel's Cycle 4 Private Equity portfolio.

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 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. Cycle 4 will be launched in 2024, and commitments for cycle 4 must be notified to Brunel by the end of March.

2.3 The purpose of this report, therefore, is to review the Fund's current allocation to the private markets portfolios – Infrastructure, Private Debt and Private Equity – and to determine whether further commitments need to be made towards Brunel's Cycle 4 portfolios.

2.4 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. 1% of the medium term target allocation was top-sliced from each of Infrastructure, Private Debt and Private Equity to create a 3% target allocation to a Local Impact Portfolio. The current progress towards achieving the target allocations is summarised in the following table.

Private Markets Allocations

Asset Class	Medium Term Target Allocation	2023/24 Target Allocation	Current Allocation as at 31 Dec 2023
Infrastructure	9%	9%	9.2%
Private Debt	4%	4%	3.4%
Private Equity	4%	3%	1.4%
Local Impact Portfolio	3%	1%	0.3%

2.5 This report provides the Committee with further details on the individual private market portfolios and the current position on the commitments made. It does not consider the position on the Local Impact Portfolio, which is addressed in a separate report on the agenda for this meeting.

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 2023

	Total Commitment[1] £'000	Current Valuation £'000	Remaining Commitment £'000
Pre-Brunel Investments			
Archmore (UBS) IIF	38,375	10,025	-
Igneo European DIF	42,915	22,013	-
Hermes IF	47,275	3,472	-
Hermes IF	47,275	38,335	-
Aviva IIF	40,000	28,891	-
Aviva Ground Rents Fund	20,000	13,992	-
	235,839	116,728	-
Brunel Infrastructure Portfolios			
Cycle I	175,000	155,704	29,695
Cycle II General	155,000	122,557	39,809
Cycle II Renewables	155,000	100,173	57,627
Cycle III	100,000	22,744	76,416
	585,000	401,178	203,547
TOTAL	820,839	517,906	203,547

Notes

1. Where the Fund is denominated in another currency, figures are based on foreign exchange rates as at 31 December 2023.

3.2 When the cycle 3 commitment was agreed the target infrastructure allocation was 10%. The Committee have subsequently agreed to top-slice 1% from the allocation to fund the local impact portfolio, bringing the target down to 9%. The current allocation has therefore reached its target, with significant commitments still to be drawn.

3.3 It is unlikely that 100% of the remaining commitments will be drawn. That which is drawn will be offset to some degree by the return of capital from the pre-Brunel funds, two of which are scheduled to close by the end of 2024. Nevertheless, the existing investments and committed capital should be sufficient to maintain the Infrastructure allocation at around the 9% target for the next 2-3 years.

3.4 It is therefore proposed that no allocation be made to Brunel's cycle 4 Infrastructure portfolio.

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 2023

	Total Commitment[1] £'000	Current Valuation £'000	Remaining Commitment £'000
Pre-Brunel Investments			
Arcmont Senior Debt Fund I	90,000	36,566	-
Golub Capital International Fund 11	60,464	51,479	-
	150,464	88,045	-
Brunel Private Debt Portfolios			
Cycle II	100,000	65,904	36,264
Cycle III	180,000	38,398	141,983
	280,000	104,302	178,247
TOTAL	430,464	192,347	178,247

Notes

1. Where the Fund is denominated in another currency, figures are based on foreign exchange rates as at 31 December 2023.

4.2 The current investment stands at 3.4%, compared to the 4% target allocation. However, there is still a substantial Cycle III commitment to be drawn. The Golub Fund still has 4-5 years left to run and is unlikely to return significant capital in the medium term. While Arcmont is nearing the end of the fund life and has returned a significant level of capital, it is still likely to be 3-4 years before all capital is returned.

4.3 The Private Debt allocation should therefore reach its 4% target through the drawdown of the current undrawn commitments, and should maintain that level for the following 2-3 years once the target is reached. It is therefore proposed that no allocation be made to Brunel's cycle 4 Private Debt portfolio.

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, including the undrawn commitments, are shown in the following table.

Private Equity Commitments as at 31 December 2023

	Total Commitment[1] £'000	Current Valuation £'000	Remaining Commitment £'000
Brunel Private Equity Portfolios			
Cycle II	126,941	68,887	58,025
Cycle III	150,000	3,238	146,743
TOTAL	276,941	72,125	204,768

Notes

1. Where the Fund is denominated in another currency, figures are based on foreign exchange rates as at 31 December 2023.

5.3 While significant commitments were made to both cycle 2 and cycle 3, the sum invested is still only just over 1%. It is hoped that the rate of investment will increase over 2024, but as with all private markets investments the full commitment is unlikely to be drawn.

5.4 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 has therefore been to build up the commitment gradually in order to manage vintage risk. Therefore, the intention was to continue to allocate to each cycle and build up the commitment slowly.

5.5 While it may be possible that the current level of commitment could take us up to the 4% target allocation, given the slow progress of drawdown and the need to commit to every cycle to manage vintage risk, it is proposed to allocate a further £100 million to Brunel’s Cycle 4 Private Equity portfolio.

5.6 Another point to bear in mind is the Government’s intention that all LGPS funds should have an ambition to invest 10% in Private Equity. This is yet to be enacted into regulation and guidance, but the Government response to the previous consultation document confirmed their intent to do so.

5.7 When the formal regulatory guidance is issued, we will still need to be happy that an increased allocation to private equity meets our fiduciary duty to manage the Fund to achieve the required investment return at the appropriate level of risk. It is suggested that this should be considered as part of the next external review of the Fund’s investment strategy, which is due in the run-up to the 2025 Triennial Valuation. Should a higher allocation be agreed, there would still need to be a gradual build-up in order to manage the vintage risk.

6) Conclusion

6.1 The Committee is asked to note the progress being made in deploying the capital previously committed to the private market portfolios. As set out, it is not proposed to make any allocation to the Cycle 4 Infrastructure and Private Debt portfolios. The next opportunity to invest in infrastructure and private debt via Brunel will be when Cycle 5 is launched in April 2026.

6.2 The Committee are asked to approve an allocation of £100 million to Brunel's Private Equity Cycle 4 portfolio. There will then be an opportunity to top this up in April 2025 if deemed appropriate.

Angie Sinclair
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Electoral Divisions: All

Local Government Act 1972: List of background papers

Nil

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