AGENDA ITEM 5

FALKIRK COUNCIL

Subject:	**INVESTMENT IN UK INFRASTRUCTURE**
Meeting:	**PENSIONS COMMITTEE**
Date:	**12 DECEMBER 2013**
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1. INTRODUCTION

1.1 This report updates the Committee on the latest developments in identifying options for investing in UK Infrastructure.

2. BACKGROUND

2.1 Previous reports to the Pensions Panel and Committee have outlined the importance of infrastructure investment in developing and growing the UK economy.

2.2 The full extent of the UK Government's investment ambitions were set out in the National Infrastructure Plan 2011 with around 500 projects at a value of £310 billion being identified as ripe for development. Specifically Scottish proposals were set out in the Scottish Government's own Infrastructure Plan 2011.

2.3 Some of the major UK Pension Funds have been collaborating recently in the Pensions Infrastructure Platform with a view to funding large infrastructure projects. At the same time, the UK Government initiative to merge some of the LGPS Funds in England and Wales is in part motivated by a desire to re-direct capital towards designated infrastructure projects.

2.4 At the Joint meeting of the Panel and Committee on 10 September, it was agreed that Officers should investigate the following three options or some combination thereof:

- Collaborate with another LGPS Fund (or investor) to establish a segregated account run by an external investment manager
- Invest in one or more of the available UK Infrastructure Funds
- Invest directly in individual projects, relying on a larger fund or adviser to undertake due diligence

2.5 The Falkirk Fund already has an $80m commitment to global infrastructure with Grosvenor Capital (formerly Credit Suisse) with roughly 25% of the funded commitment being invested in UK infrastructure.

3. UK INFRASTRUCTURE INVESTMENT

3.1 There are good reasons why investment in the UK infrastructure market should be undertaken with a degree of caution. The UK is one of the best-established and stable markets globally and therefore attracts many investors. Secondly, with the rise in equity and bond prices, many UK pension funds are looking to diversify into infrastructure. Collectively, this has created an environment where there is a serious risk that investors may pay too much for their share of the infrastructure cake, with a materially negative impact on the return.

3.2 Nonetheless, the LGPS is increasingly being seen as a source of funding for myriad investment opportunities. As an example, the Lancashire County Council Pension Fund has recently agreed to re-allocate £100m of its funds from global equity to local infrastructure. Such deals are normally characterised by the pension fund being a willing partner rather than the architect or visionary behind the deal.

3.3 The Falkirk Fund's investment adviser has previously advised that since the Fund already has a 5% allocation to global infrastructure, a maximum of around £30m should be allocated to any UK Infrastructure mandate.

3.4 The investment adviser has also counselled against a purely Scottish focussed investment strategy on the basis that this represents an over concentration of risk, including the risk of reputational damage.

3.5 The following sections look in more detail at the options taken forward from the last Panel/ Committee meeting.

4. COLLABORATION WITH LOTHIAN PENSION FUND

4.1 The Committee will be aware that, since 2011, the Fund has had a successful relationship with the Lothian Pension Fund (LPF), with LPF providing Falkirk with investment manager monitoring and related support.

4.2 As part of its investment arrangements, LPF employs a team of qualified investment specialists who currently manage over 50% of the Fund's assets in-house. This includes regional and global equity mandates as well as infrastructure. Because they are being managed internally, the cost of operating these mandates is considerably less than the cost of externally managed funds.

4.3 The LPF team includes an experienced manager in infrastructure investing. Against the backdrop of shared services initiatives in local government and developments down south encouraging fund alliances, a joint approach to infrastructure would be an opportunity for the Falkirk and Lothian Funds to demonstrate their commitment to shared working and for the Falkirk Fund to gain access to UK Infrastructure on a low cost basis.

4.4 The Lothian approach to infrastructure is to target primary and secondary funds, as well as co-investments. Having a "partner" investor would give the Lothian team greater negotiating clout in closing deals with infrastructure funds. The benefit for Falkirk would be the ability to tap into specialist infrastructure support without facing as large a fee as would be the case with a Fund of Funds structure.

4.5 Lothian places its infrastructure assets in its "Alternatives" portfolio. Its target return net of fees is RPI + 3.5%, giving a nominal return of around 6%. The fee charged by Lothian would be subject to negotiation but would be not more than 0.20% of Net Asset Value which compares favourably with fees charged by external managers.

4.6 Lothian has a robust process in place for reviewing potential infrastructure investments. This includes a preliminary report, which analyses the management team, investment strategy, process, and track record of the investee fund. The report is discussed with members of the Lothian internal investment team including the Portfolio Manager, Investment Manager, the internal lawyer and the Investment & Pensions Service Manager. If deemed worthy of serious consideration, further due diligence is undertaken before a final decision is authorised by the Investment and Pensions Services Manager.

4.7 Lothian Pension Fund is not registered to give financial advice nor undertake investment management for third parties. Accordingly, in order for the above proposals to be workable, an arrangement would have to be entered into which would allow relevant members of the Lothian team to be seconded to Falkirk Council when undertaking Falkirk Fund investment activities. This would require to be approved by Falkirk Council's Legal and HR specialists.

4.8 If Committee were supportive, then in order for the arrangement to work, the Pensions Committee would require to delegate the infrastructure investment decision making process to the Chief Finance Officer of Falkirk Council. As this would be a shared service arrangement the Lothian team would effectively become an extension of the Falkirk Council Pensions section. The Pensions Committee would require to agree investment parameters that were similar to Lothian's and the Chief Finance Officer would be able to decide on the degree of involvement of existing Falkirk Officers. This is similar to the situation where the Pensions Committee delegates the investment decision to external managers.

4.9 If this arrangement for infrastructure investment was found to be successful, then further elements of the Falkirk portfolio could potentially follow a similar approach. This would of course depend on there being sufficient alignment of investment strategies between the two funds and an appropriate governance structure.

4.10 Subject to Legal and HR considerations, the Fund could utilise the resource and expertise of the Lothian Fund in relation to UK infrastructure without having to undertake a competitive tendering exercise. This is on the basis that the venture would be a shared service arrangement.

5. SEGREGATED FUND

5.1 The investment adviser has previously indicated that SL Capital would be willing to set up a segregated account for Falkirk Council. Recent discussions with SL Capital have indicated that they would now be prepared to establish such an account for a minimum investment of £30m, however, in order to achieve a sufficient degree of diversification, they would be more comfortable with a slightly larger investment of £40-£50m. SL Capital advise that they are exploring the potential for another LGPS Fund to co-invest in order to increase fund size and thus allow there to be greater diversity of investment content.

5.2 Their proposition would be to invest the Fund entirely in UK infrastructure with up to 50% in Scottish projects. Investments would be in Primary and Co-investments with limited ability to make opportunistic fund investments.

5.3 Key terms would be as follows:

Management Fees	-	0.80% of Net Asset Value (e.g. £240k p.a. on £30m investment)
Carried Interest	-	Nil
Portfolio	-	5 – 6 investments
Net IRR	-	8% - 10%
SL Investment	-	SL Capital team would invest 1% in the Fund

5.4 SL Capital also offer a pooled Infrastructure Fund on basically the same terms as above, except that the Fund is likely to be invested 2/3rds in the UK and 1/3rd in Western Europe and the Nordics.

5.5 Whilst the above proposition is attractively priced, there would also be fees arising from the underlying funds into which SL Capital would be investing.

5.6 It is noted that whilst SL Capital have a global reputation for raising capital in private equity markets, their pooled infrastructure fund (or indeed any new segregated fund) will be their first direct foray into that asset class.

5.7 The investment adviser notes that other managers may be prepared to create a segregated fund for Falkirk and therefore an investment with Standard Life in either the segregated or pooled product could only be made after a competitive tendering exercise.

6. INVESTING IN UK INFRASTRUCTURE FUNDS

6.1 A number of well-known managers operate UK focused infrastructure funds. The more prominent of these were listed in the report to the Joint Meeting of the Panel and Committee on 10 September 2013 and included Aviva, Dalmore Capital, Equitix, and Hermes.

6.2 Each of these would be pooled funds and therefore the Falkirk Fund would have no influence over the geographical focus of the investments. In short, Falkirk would not be able to dictate that a proportion of the investments be directed towards Scotland.

6.3 The available infrastructure funds fall into two categories. Funds such as the Hermes GPE Infrastructure Fund, which are invested in a range of underlying infrastructure funds, and others such as the Aviva REALM Infrastructure Fund which tend to invest directly into individual, but related, projects (e.g. energy efficiency). The former has the advantage of diversity but is, in essence, a fund of fund structure which would attract a double layer of fees. The latter has a narrower range of assets under management, but avoids the drag of additional fees.

7. INVESTING DIRECTLY INTO SPECIFIC PROJECTS

7.1 The majority of options laid out thus far do not involve investing directly into specific projects. Most involve investing into a Fund from where a qualified manager will either invest into another Fund or undertake a co-investment. This strategy is geared to minimising the investor's exposure to risk.

7.2 As an alternative or in conjunction with the options set out in Sections 4, 5 and 6 above and subject to the advice of the Fund's investment adviser, the Panel and Committee could agree that a small segment of the Fund be reserved for the purpose of making opportunistic investments, which could conceivably be of a local nature. Whilst this has the potential of getting local capital into local projects, it comes with the following caveats:

- the risk of members being heavily conflicted (i.e. balancing the interests of the Fund with the interests of local constituents);
- the risk of Panel and Committee spending a disproportionate amount of time on what would be a miniscule part of the Fund at the expense of focussing on major strategic issues;
- the risk of tensions if capital is not invested equally across the Fund's geographical area
- the risk of reputational damage if a local investment project were to fail

7.3 Should the Committee wish to create an "Opportunities Fund", then it would be essential to devise a specific Opportunities Fund strategy to document issues such as:

- the objectives of the Opportunities Fund (e.g. allocation, target return)
- the investment evaluation process (e.g. risk, return, liquidity, investment time horizon)
- funding the investment (e.g. from equities, bonds, cash, etc?)
- does the investment meet objectives?
- conflicts of interest
- risk to reputation
- exit strategy

In addition, to guard against the Fund being inundated with a succession of spurious investment propositions, there would have to be a preliminary fast track screening process so that only propositions with genuine investment credentials would be considered. Effectively, investment ideas would have to demonstrate a capacity from the outset to deliver an attractive return (i.e. at least 6% p.a) for an acceptable level of risk.

7.4 The strategy should be sufficiently flexible as to consider proposals from a variety of sources. However, it must be accepted that due diligence and project evaluation are not activities that could be undertaken in-house given current resources. There is therefore a real risk that the cost of external expertise could be disproportionate in terms of the overall level of investment being considered.

7.5 In terms of Fund investments, it is considered that Panel and Committee should set the overall investment strategy and that the actual investment decision be made by external managers. In the case of an Opportunities Fund, the likelihood is that any final investment decision would be delegated to the Chief Finance Officer.

7.6 Consultation would be required with the Fund's investment adviser to determine the best way in which to publicise the Fund and to undertake due diligence, project evaluation, etc.

8. CONCLUSION

8.1 The Committee would appear to have a number of options open to it in relation to its interest in making an investment in UK infrastructure.

8.2 Subject to Legal and HR considerations, the Fund could extend its ongoing service level agreement with Lothian Pension Fund so that the Lothian in-house investment team made investments in UK infrastructure on behalf of the Falkirk Fund. This could be of mutual benefit to both Funds and would be a visible demonstration that LGPS Funds can align their interests and work together without having to initiate a full scale fund merger.

8.3 As an alternative to the Lothian proposition, the Fund could tender for a manager to run a £30m-£40m segregated account investing in UK infrastructure but with a substantial Scottish content. Falkirk would have significant control at the outset in dictating the terms of the mandate, but returns would be diluted by the double layer of fees arising from the fund of funds structure. This is the type of proposition being advanced by SL Capital.

8.4 As a further alternative, the Fund could tender for a manager to run a £30m-£40m mandate that would invest in UK infrastructure such as the infrastructure funds run by Aviva, Hermes, etc. Falkirk would have no control over the placement of investments and returns could be diluted as a result of the double layer of fees if a Fund of Funds structure is involved. This type of proposition is similar to the pooled fund being advanced by SL Capital.

8.5 If the Committee's preferred option were to be the Lothian proposal, it would seem appropriate to consult the Fund's investment adviser to determine whether the Lothian's proposition was sufficiently aligned with Falkirk's own investment strategy in terms of the risk/ return profile and relative to alternatives.

8.6 As an alternative or, more likely, as a supplement to the options outlined above, the Committee could consider establishing an Opportunities Fund for the purpose of making opportunistic investments. This option would require significant groundwork to establish the formal framework within which the investment opportunities could be sourced and evaluated. There would be material costs both in terms of Officer time and the professional input needed.

9. RECOMMENDATIONS

9.1 The Committee is asked to decide which, if any, of the following investment options relating to investment in UK infrastructure, it wishes to pursue:

(i) Collaborate with Lothian Pension Fund
(ii) Tender for a manager to run a segregated mandate (e.g. SL Capital)
(iii) Invest in pooled infrastructure fund(s)
(iv) Invest opportunistically in specified projects

9.2 In terms of the decision made in paragraph 9.1 above, the Committee requests that the Chief Finance Officer:

(i) consults the Fund's investment adviser as appropriate, including the initiation of a tender process if required, and
(ii) reports back with a progress update at the next Committee meeting.

Chief Finance Officer, Tel: 01324 5063000

Date: 28 November, 2013

<u>BACKGROUND PAPERS</u>

NIL