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Room151's
LGPS Briefing

PRIVATE MARKETS PROFILE

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Introduction

The LGPS has a long and arguably successful history of investing in listed securities, and while direct real estate has also played a significant role in portfolios reaching back decades, most illiquid and unlisted opportunities remain relatively untapped by the scheme, when compared to many global institutional investors.

In the last ten years a number of political, investment and environmental drivers have moved LGPS asset allocators to rethink this. Firstly, there is the need to explore alternatives to long-term returns for open defined-benefit schemes. The old 60/40 orthodoxy that served administering authorities reasonably well, is now viewed by many as outdated or at least in need of modification, with an allocation to private assets needed to round the portfolio even if they are equity and fixed income in nature.

Secondly, there is pooling, the defining drivers of which were to achieve economies of scale and access more private opportunities, such as infrastructure, where size matters. Most administering authorities didn't have sufficient clout in isolation but now they do, in aggregate.

Thirdly, there are net zero and impact. The LGPS as a global investor has signed up to Paris-alignment with zeal, which likely means more private markets activity than ever if funds are to access long-term drivers or decarbonisation, such as energy transition infrastructure. While the LGPS as a local investor – potentially allocating up to 5% in UK-wide 'local' investments – may also see private markets opportunities lend themselves more readily to this classification.

LGPS pools dealt efficiently with listed securities, but it's ultimate success may be won or lost in the private markets space. The pooling of passive equity, for example, was I'm sure not an entirely straightforward business, but private markets is a different ball game. The skills requirement is different, the risks are different, the engagement required is different and if you get it wrong, by definition, it's harder to get out of.

If administering authorities continue to drive demand for more private markets investments, the pools will need to meet that demand. And how they do that may become a defining feature of their overall prospects in the decade ahead.

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CGRs: providing long-term, inflation-linked cashflows to help meet pension payments

Alpha Real Capital's **Boris Mikhailov** examines why commercial ground rents have been one of the fastest growing areas of secure income and why now is a sensible time for LGPS investors to consider an allocation.

Commercial ground rents (CGRs) are a commonly used financing tool by real estate owners or acquirers, who sell the freehold of the property and typically lease it back for 99+ years. The parties to a CGR are akin to a borrower and lender, although the relationship is governed by a lease, not a loan (see Figure 1).

For Local Government Pension Scheme (LGPS) investors (the 'lenders'), CGRs are an asset that provides secure, long-dated, inflation-linked cashflows providing reliable income returns as well as inflation-linked capital growth (see Figure 2).

How has the market grown?

In the UK, CGRs have been the fastest growing segment of the institutional long income real estate market in recent years, growing from virtually nothing to circa £5bn in just over five years with the market expected to reach £20bn within the next decade. There are £2bn+ per annum of investment opportunities across traditional real estate sectors, as well as alternative sectors that include hotels, leisure, pubs, garden centres and healthcare.

Current investors include LGPS funds, corporate defined benefit schemes and fiduciary managers, with insurers entering the market more recently.

The investment characteristics for LGPS funds

CGRs are particularly attractive for LGPS investors in the current market environment because of the following characteristics:

- **Inflation protection:** CGRs provide very long dated cashflows that are contractually inflation-linked. This should make them attractive to LGPS investors concerned about meeting future inflation-linked cashflows.

- **Security of cashflows:** the cashflows are highly secure, achieved through significant over collateralisation of both the income and capital. The leaseholder (borrower) will typically have operating income that covers the annual ground rent approximately eight times, and at the outset the value of the underlying asset is typically two and a half times that of the capital advanced. Further security of cashflows is achieved through the CGR investor effectively being the most senior lender along with most CGR assets being assessed as investment grade, typically clustered in the single A category.

- **Stability of returns:** CGRs can provide diversification from publicly traded assets and have performed strongly during periods of market volatility.

- **ESG benefits:** CGRs can provide strong and quantifiable ESG benefits, depending on design. For example, a large percentage of CGRs are in social infrastructure assets that provide positive societal benefits. This means CGRs should be attractive to LGPS investors looking to further their ESG ambitions.

FIG 1: DEAL STRUCTURE

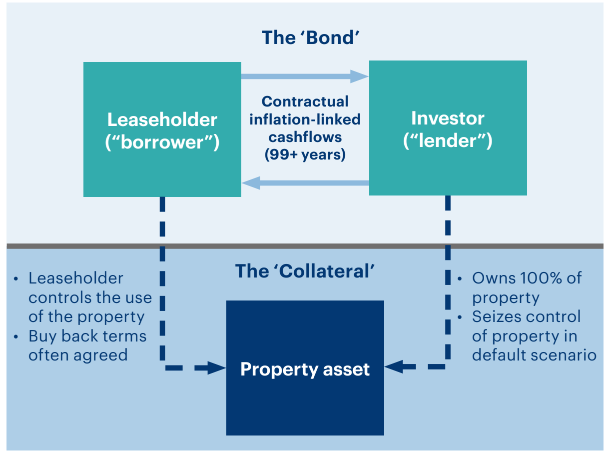
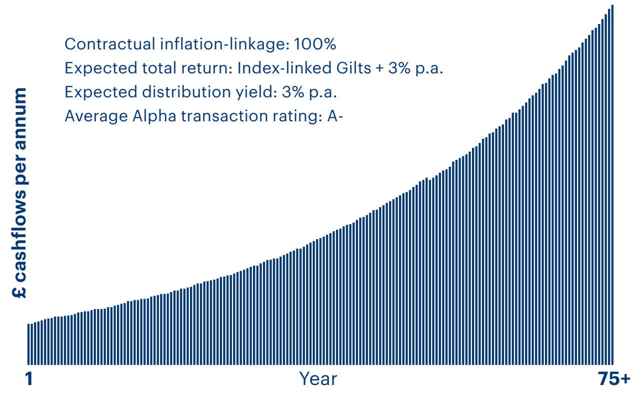


FIG 2: ILLUSTRATIVE CASHFLOW PROFILE



Source: Alpha Real Capital, for illustration purposes only. Cashflow profiles and investment characteristics are indicative and based on Alpha Real Capital's Index Linked Income Fund (as of 30 September 2022)

In the UK, CGRs have been the fastest growing segment of the institutional long income real estate market in recent years, growing from virtually nothing to circa £5bn in just over five years.

Volatile period

The characteristics highlighted in this article evidence how CGRs could provide LGPS funds with the secure inflation-linked cashflows they need to pay member benefits through this period of volatility.

With funding levels expected to have improved for many funds along with large inflation increases coming through from April 2023, now would be a sensible time for LGPS investors to consider an allocation to this asset class.

While these are simple assets, they are not simple to source. Therefore, the ability to originate high-quality CGR assets is key to success in this space and something LGPS investors considering an allocation should focus on when assessing managers.

Boris Mikhailov is head of client solutions at Alpha Real Capital (borismikhailov@alpharealcapital.com)

Direct infrastructure: building sustainable returns

Stephen O'Shea from Igneo Infrastructure Partners discusses why infrastructure continues to be popular with pension fund investors and outlines the benefits of using direct infrastructure managers.

Real assets has been an asset class very much in favour with investors over the last few years. Allocations continue to increase, with pension funds particularly attracted to the long duration profile of the opportunities. Within the wider real assets arena, direct infrastructure has been a clear focus for investors. Why has this been the case and what is the most effective approach to managing direct infrastructure investments?

Why infrastructure, why now?

To start with, let's consider why infrastructure has proven so popular with pension fund investors. The primary attractions are clear:

- **Asset/liability matching.** The long duration nature of many infrastructure assets (such as energy, transportation, utilities and communications networks) aligns well with the liability profile of many pension funds.

- **Low volatility.** Returns from unlisted infrastructure assets have proven less volatile versus other asset classes, such as equities. Given the long-term nature of the underlying assets and their typically regulated or contracted revenue models, this is not surprising.

- **Genuine diversification.** Core, unlisted Infrastructure assets demonstrate low correlation to economic and market cycles, and therefore provide genuine portfolio diversification benefits.

- **Dependable yield.** Often with contracted or regulated business models permitting long-term sustainable returns, income streams benefit from indexation and high visibility and predictability.

- **Stability.** Essential service provision, long-term debt profiles and regulated/contracted business models make infrastructure assets relatively resilient to economic volatility, rising interest rates and inflation, and thereby offer stable returns over the long term.

Perhaps given the current global economic backdrop, it is unsurprising that infrastructure has maintained its mantle as one of the most attractive areas for pension funds. However, while these attractions are applicable to the overall asset class, different approaches to the management of infrastructure assets within a portfolio can yield different results.

Different approaches yield different results

One of the most powerful and effective elements of an ESG-led proactive asset management strategy is the opportunity it creates to forge a genuine partnership with the investee businesses. This is most effectively achieved through the direct infrastructure investment route where, as sole or lead shareholder, direct infrastructure investors proactively work with company management teams implementing and driving long-term business plans creating long-term sustainable value.

One of the largest global direct equity infrastructure investors, Igneo Infrastructure Partners, has been doing this for 30 years. Managing around US$15bn* of client assets, Igneo provides an insight as to how asset managers can add operational value and build sustainable growth. As the lead shareholder, direct infrastructure investors such as Igneo drive business strategy at board and operating level and help define and thereby manage risk.

> *One of the most powerful and effective elements of an ESG-led proactive asset management strategy is the opportunity it creates to forge a genuine partnership with the investee businesses.*

As a global manager, Igneo's portfolio of businesses are located across continents and are represented by a diverse range of sectors. The opportunity therefore exists to share experiences and expertise, promote technology transfer and generally leverage the learnings across the wider portfolio and add value to individual businesses. For ESG-led and proactive managers such as Igneo, a prerequisite to investment is the ability to apply operational knowledge and innovation to develop sustainable businesses that stand as leaders within their fields.

ESG – an investment opportunity

This process of adding value is driven by an approach to proactive asset management that has been ESG-led since we began investing in direct infrastructure businesses. An understanding that partnering with investee businesses to help integrate ESG best practice is not a cost, but an opportunity. Real value is created through securing the long-term sustainability of businesses, improving workplace health and safety, strengthening governance across the business, establishing improved diversity and long-term management succession planning within the workforce and implementing net zero emissions plans.

An ESG-led focus on proactive asset management helps identify, manage and mitigate risk, as ESG failings in high-profile businesses causes reputational risk and inevitably impairs asset values. Constructive ESG engagement with company management not only mitigates risk, but presents opportunities to add value.

On environmental issues, investments in green technology can improve energy efficiency, reduce emissions and lower operating costs, such as through the substitution of fossil-based energy sources with renewable or hybrid alternatives. Macro trends and growth drivers, such as electrification of transport, require additional investment to expand energy grids, build charging infrastructure and promote wider adoption of renewables and energy storage.

Direct infrastructure investors can access these investment opportunities and provide the capital required to deliver innovations and secure the benefits they can bring.

With the correct approach to asset management, direct infrastructure managers are able to enhance the returns available from the asset class. Managers such as Igneo can leverage expertise gained from across their portfolio to enhance processes, mitigate risk and create long-term sustainable value. It all comes down to a proactive management approach that is genuinely ESG-led. The reward is building sustainable infrastructure businesses to the benefit of all stakeholders, not least investors.

Stephen O'Shea is head of investor and consultant relations, Europe, for Igneo Infrastructure Partners.

* Source: First Sentier Investors, as at 30 June 2022

Getting 'punchy returns' from energy transition funds

Mike Thatcher investigates Wandsworth Pension Fund's planned £80m investment in non-traditional renewable energy projects.

Wandsworth Pension Fund (WPF) has agreed to invest up to £80m in two energy transition funds based on non-traditional renewable projects such as battery storage and green hydrogen.

WPF, which also includes Richmond Council's Pension Fund, said that, subject to due diligence, it intended to invest in the Octopus Energy Transition Fund and the Sandbrook Climate Infrastructure Fund. A maximum of £50m will be invested in one fund, with the total across both not exceeding £80m.

Paul Guilliotti, WPF assistant director (financial services), told Room151 that Wandsworth already had significant investments in traditional renewable energy projects – involving generation – and was looking for strong returns and the opportunity to diversify its portfolio.

"Our approach was not aimed at investing in sustainable assets at any cost. First and foremost, it was diversifying and adding in something different to our return profile," he said.

Guilliotti said he was expecting "punchy" returns on the investment of between 12% and 16%.

Due diligence

He suggested that WPF had "committed with a soft C rather than a hard C" on the investment, and the final go-ahead would be determined by the due diligence process.

The Octopus fund will focus on hydrogen, the grid, storage, supply chains and local renewable generation, while the Sandbrook fund will focus on generation, grid, storage, supply chains and energy efficiency.

Wandsworth's total fund value is £2.8bn. It has set a net-zero target of 2050, with the goal of achieving a 60% reduction in emissions by 2030.

Guilliotti discussed WPF's approach at Room151's LGPS Investment Forum on 2 November at the London Stock Exchange.

"Our approach was not aimed at investing in sustainable assets at any cost. First and foremost, it was diversifying and adding in something different to our return profile."

Paul Guilliotti, assistant director (financial services), Wandsworth Pension Fund

Pension pooling and the infrastructure imperative

David Vickers, Brunel Pension Partnership's chief investment officer, talks to **Mike Thatcher** about infrastructure investment, levelling up and the future for LGPS pooling.

What is the future of the Local Government Pension Scheme (LGPS) pooling system? This is a question that has been asked for months, if not years, as we await the government's long-promised review of a structure that currently comprises eight pools with around £300bn of assets.

Ministers are said to be "impatient" about the progress made on transitioning assets to the pools, while believing that LGPS pension funds could do more to support UK-based infrastructure projects. There are hints that rationalisation of the pools could be on the agenda, that pooling of assets could be made mandatory or even that individual LGPS funds could be members of different pools for different purposes.

But government turmoil – with three levelling up secretaries in the past four months – has led to delays to the publication of the review and a lack of clarity on future direction.

An early indication of the government's intent could be seen, however, from the levelling up white paper, published in February 2022. This called for LGPS funds to allocate 5% of assets to infrastructure projects that support "local areas" (later clarified to mean UK-based) with the aim of unlocking £16bn of new investment.

So how could pension funds be used to support UK infrastructure projects more effectively and what impact would pool rationalisation have? Room151 talked to David Vickers, chief investment officer of the Brunel Pension Partnership, to get a view from the frontline.

MT Do you think that with Michael Gove returning as levelling up secretary there will be more emphasis on using the pools to invest in UK infrastructure?
DV Potentially. I would imagine [the LGPS] looks like a prize, an untapped resource of capital. We have spoken to the government and said if you want more money in infrastructure, then invite us to the table. We wrote to [former minister for investment] Lord Grimstone, and to Boris Johnson [when he was prime minister], and I've had meetings with the Office for Investment, saying "show me the deals you have, and then I can show you our commitment". But I can't commit a number to an unknown project.

At COP26, the government invited international investors, but not the UK investors. They either want us at the table or they don't, but we need firm projects that we can invest in, that meet our fiduciary responsibility. We can't invest in opportunities that are subpar just because they are government derived.

MT The levelling up white paper called for LGPS funds to invest 5% of their assets in local infrastructure projects. Is that happening?
DV It doesn't feel like it. But most of our clients, in the aggregate, probably already have about 5% in infrastructure. Not all in the UK, lots of it is global, but there are place-based Investing schemes such as the £115m investment in affordable housing by Cornwall Pension Fund – the first multi-asset, place-based impact fund across the LGPS pools.

> *"We need firm projects that we can invest in, that meet our fiduciary responsibility. We can't invest in opportunities that are subpar just because they are government derived."*
> David Vickers

Everything in your portfolio has to compete for attention. If UK infrastructure is a lower-returning investment than global infrastructure, how does that work? I have to choose the best available risk-return opportunities that exist within that particular asset allocation. You also get more diversification in global and different opportunities.

Twenty years ago everyone invested only in UK equity markets and gradually moved to global. They've won on the back of that because, not only have you had Amazon, Apple and Google, you've had the currency depreciation. I am not saying that will happen again, but diversification is the key to lots of things.

MT What would be the optimum size for each LGPS pool?
DV We have conducted studies looking at successful asset owners elsewhere, and somewhere around £100bn is an optimal amount of money. So you could imagine policymakers trying to push the eight pools down to four or three.

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David Vickers

We looked at sovereign wealth funds in Canada, Australia and Norway, employing an independent consultancy to examine the optimal amount of money, because economies of scale stop at a certain point. If I have $200bn to negotiate with, rather than $100bn, I don't get a better deal. If I have $100bn rather than $10bn, I do get a better deal. So there is the optimal point in the curve where efficiency gains and economies of scale start to lessen. You don't really want to go past that.

It's an open question, but it does strike me that probably eight would be a funny number to stop at and another government has its own incentivisation for a bigger pool that they could arguably control – with local levelling up and infrastructure. They see perhaps the prize of a sovereign wealth fund, which would act differently to how the pools currently act.

MT What do you think of the suggestion that an individual LGPS fund could be a member of a different pool for different purposes?
DV Each pool has a different governance structured agreed corporately by its clients. That makes it hard to invest in other pools' portfolios without accepting different governance rules. Moreover, the bill for creating any portfolio has already been footed by the clients invested in it. So appropriate price would have to be agreed for the service in recognition of those costs.

Perhaps it would make more sense for a pool to take on money that the other pools aren't providing or can't provide or don't want to provide, or it's uneconomic for them to provide. That might make sense. But, again, you'd have to overcome the governance issues. There are lots of sunk costs in the pools, and our clients have borne those costs, so to have a free ride might be difficult.

MT You have transitioned 80% of the assets from individual funds to the Brunel pool. Can you go further?
DV Maths would tell you that you may as well get to 100%. However, most of the low hanging fruit [has been taken]. Some of the funds already have private market programmes that will be invested for the next nine to ten years. And there are some clients that have a manager that only they have, or an asset class that only they have. What is the point in us replicating what they already have?

Pooling was established for the economies of scale amongst other things. If it's one client who only has a small holding, I probably couldn't replicate that any cheaper. So why transition and create costs?

MT So when the government does publish its long-awaited response on the future of pooling, what do you want to see?
DV Clarity. The previous reviews we've had historically have stopped short of mandating certain things, whether in renewables or infrastructure or anything else. And so it should be either: mandate or don't mandate. There should be no halfway measures.

Five tips to find the right fund manager in private markets

Redington's **Nick Samuels** discusses the best way to select (and deselect) fund managers in private markets, where information is less standardised and data often inaccessible.

Manager research is all about finding the best funds and managers globally, and creating a process to screen, select and monitor them to ensure they do the job they were hired for. The process also needs to support appropriate deselection when the circumstances arrive.

So, if we're looking at the research process, what are the top tips that really help us to understand a manager, their process and select the most appropriate strategies for our clients?

1. Face-to-face interaction
Meeting managers face to face, at their office and going to site visits, ensures the deepest, most rich approach to manager research. You'll learn far more from this than you will from the most detailed request for information, particularly in private markets where information is less standardised and sometimes less regulated.

2. Data is crucial
Data isn't very accessible in private markets, so having access to clean data via the right channels, as well as good systems and software to analyse it is fundamental to good research. Using technology to facilitate early-stage research is an excellent way to conduct initial screening and manage time and resources efficiently.

3. Strong and continued engagement
Relationships and transparency matter in private markets where information is opaque. To be able to source better information from a manager and cement your understanding of their process, continued and longstanding engagement is crucial. These are long-term investments that require long-term relationships so take your time.

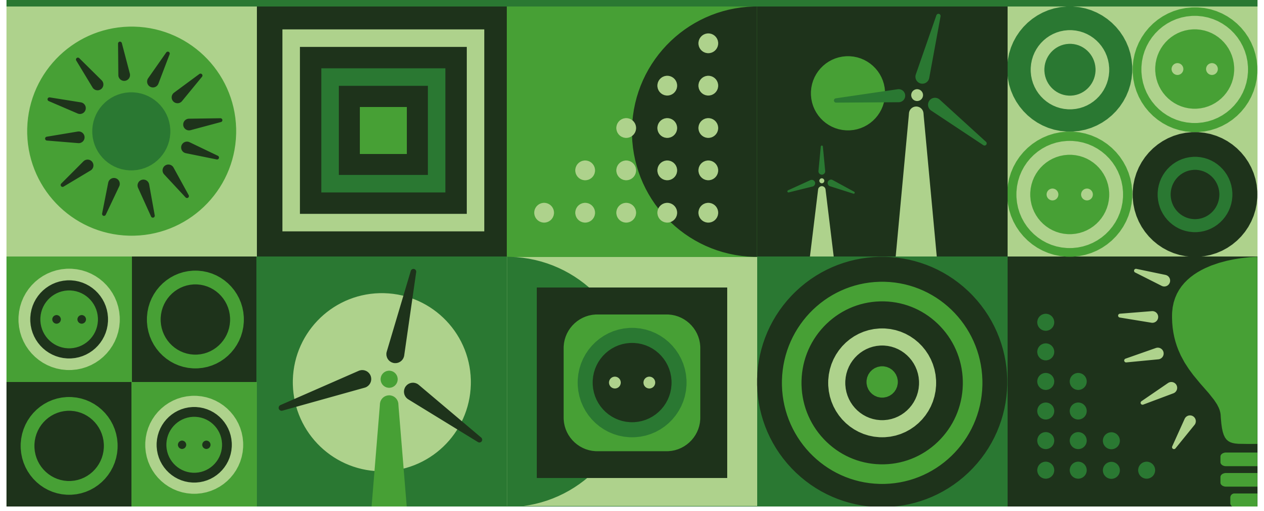
4. It's all in the answer
It's as much about listening to the answers as asking questions. When you engage with a manager, do their answers feel formulaic? How do they construct the answers to your question and how open are they when they don't have an answer? ESG is a great example here – managers write in their documents that "ESG is integrated into the process", but you'll often find that when speaking with them, they either do not reference it at all or talk all policy and no practice. It should be integrated, but can be siloed to a different team or part of the business.

5. Same question, different people
It's always useful to ask different people the same/similar questions – this will really show if a team is cohesive in its long-term plans from senior to junior, chief investment officer to analyst, or whether the individuals are deferring to a colleague or learning from a script.

Nick Samuels is head of manager research at Redington.

Driving climate impact through private equity

Franklin Templeton's **Richard Piliero** explains why private equity is well placed to drive an investment framework focused on climate impact for a just transition.



We are at an inflection point in harnessing the financial system to drive sustainability and innovation. Public and private debt and equity funds play a role in advancing impact-driven practices and policies. While the former drive change by engaging companies in public markets, the latter can help build better impact practices from the ground up.

Private equity has a vital role to drive impact, especially in emerging and frontier markets. By nature, private – and, in particular, private equity – markets are well positioned to drive positive, lasting, impact-driven practices that foster improved performance. They have a unique toolbox, including:

1. Deep engagement: private equity firms engage with portfolio companies at board level, allowing them to influence key decision-makers to adopt and strengthen impact practices.

2. Long-term relationship: the longer-term nature of private equity investments, typically over five to seven years, allows for more effective measurement of the climate impact of an investment.

3. Contractual enforcement: private equity firms can embed impact best practices into transaction documents and company charters as a precondition for investment.

4. Increased level of detail: private equity firms often benefit from higher levels of information transparency than public market investors. This level of granularity helps improve the issue of data materiality.

5. Iterative process: the process of driving positive impact is inherently iterative, which follows a nonlinear "theory of change". Private equity has the benefit of a close and constant relationship with investee firms to build better impact practices through a regular, long-term feedback loop. Since impact measurement and reporting is a relatively new and evolving field, investee companies benefit from this ongoing hands-on investor guidance.

Integrating climate impact in the investment process

The recent Intergovernmental Panel on Climate Change (IPCC) report highlighted what we can all observe – that global warming is real and driving consequential climate change. Our call to action to find solutions through investing in innovative companies needs to incorporate impact assessment in earnest. We believe end-to-end integration of impact in the investment process is critical to developing a private equity impact management framework.

We believe a framework should start with an "Investment and Impact Thesis". This needs to focus on the proper management of financial capital to foster returns, alongside human and natural capital performance measurement to ensure sustainability. Essentially, this should drive climate change mitigation by promoting energy transition toward a low-carbon economy, and supporting adaptation through greater economic resilience of populations affected by climate change. This could be particularly effective in a private equity context as investment, capital and expertise are provided to growth-stage companies addressing these challenges.

Such an impact management framework would then imply impact integration consistent with the thesis at each stage of the investment process:

1. Deal sourcing: climate investment and impact objectives
In the deal-sourcing stage, the investment impact thesis would be well developed, involving a coherent impact narrative and data points for each investment. Systematic analysis would identify the specific human and natural capital challenges being addressed, the enterprise- and investor-level activities that will enable progress, and the measurable impact outputs and higher-order outcomes being targeted toward enhanced risk-adjusted returns.

2. Deal structuring: contractual obligations
Apart from the typical financial and risk-mitigation measures, investors can embed deal-specific impact measurement and management measures into transaction documents. For example, the sales and purchase agreement can stipulate "conditions precedent" and "conditions subsequent" to deal closing.

3. Partnership: building value
To help steward the company, the private equity team can engage closely with boards, management and operating teams. This extends to helping portfolio companies adopt and implement impact standards and frameworks and systems to measure and report on climate impact key performance indicators.

4. Exit: creating value by reducing risk
A successful exit is one that realises the financial gains brought through a successful investment thesis, which is underpinned by sustainability considerations. Incorporating impact considerations into a company's policies and practices can reduce risks for a buyer and raise company valuation, thereby helping a successful exit be that to public markets or via a strategic sale.

By nature, private – and, in particular, private equity – markets are well positioned to drive positive, lasting, impact-driven practices that foster improved performance.

Potential to drive alpha

Stepping back, we believe strong impact practices overall have the potential to drive alpha in portfolios. A focus on climate is where impact and financial return become mutually reinforcing and beneficial for key stakeholders including communities, employees, governments, businesses and investors.

With the right tools and impact approach, private equity is well placed to drive an investment framework focused on climate impact for a just transition, as envisaged in the Paris Agreement.

Richard Piliero is managing director of Franklin Templeton Global Private Equity.