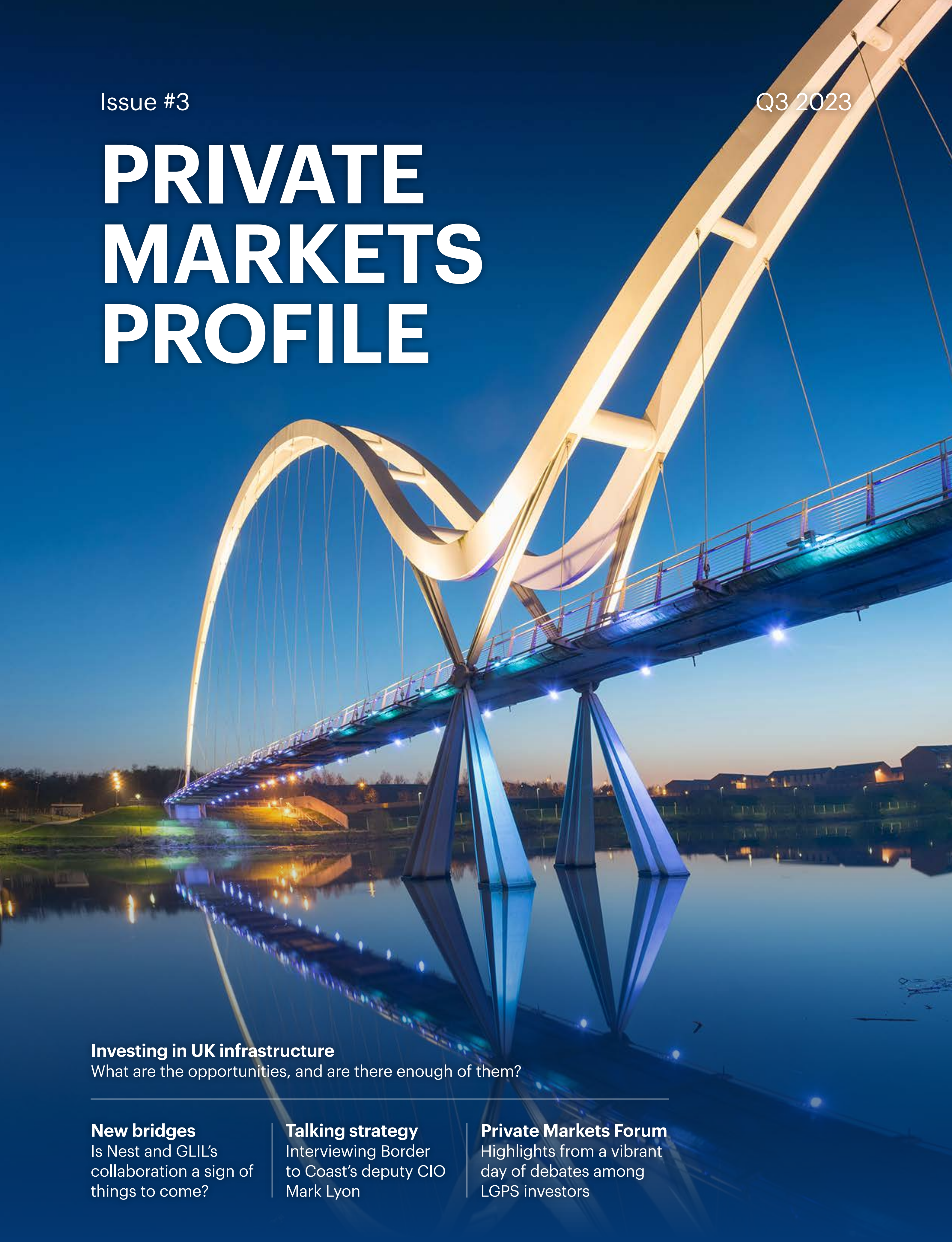

Issue #3

Q3 2023

PRIVATE MARKETS PROFILE

Investing in UK infrastructure
What are the opportunities, and are there enough of them?

New bridges
Is Nest and GLIL's collaboration a sign of things to come?

Talking strategy
Interviewing Border to Coast's deputy CIO Mark Lyon

Private Markets Forum
Highlights from a vibrant day of debates among LGPS investors

Sponsored by

Edmond de Rothschild

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Ninety One

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Introduction

From the renewable energy transition in road and transport networks to investments in water, the UK economy is in desperate need for cash. The government is keen to tap into private markets as a funding source, with the LGPS being seen as key potential investors.

As this issue of the Private Markets Profile went to press, chancellor Jeremy Hunt released detailed plans for attracting institutional cash in his Mansion House speech alongside the results of a consultation on the future of the LGPS, pushing the topic of investments in the UK to the top of investors' agendas.

This issue is focused on the opportunities and potential risks of investing in the UK, which will be explored in our cover story. Investors explain why private markets in the UK might have a competitive edge over other regions.

Hunt's pitch for institutional cash ties in to growing institutional demand for private markets as a potential source of portfolio diversification amid an increasingly uncertain economy environment.

But while the government is keen to see institutional money being put to work in the UK, it has to strike a careful balance to avoid being overly prescriptive on asset allocation, which would be vehemently opposed by the LGPS.

Meanwhile, for the LGPS, investments in local communities and infrastructure are a strong story to take back to members, but they have to weigh it carefully against potentially higher risks and the need to maintain geographically diversified portfolios.

The growing demand for private markets was also a key theme at Room151's first Private Markets Forum, held at the London Stock Exchange in June. The event drew a large crowd of LGPS investors and consultants and sparked plenty of vibrant debates. A summary of the events can be found in this issue.

This profile wraps up with a case study on Nest's investment with the LGPS infrastructure platform GLIL. We speak to GLIL's Ted Frith and Nest's head of private markets Stephen O'Neill about whether this collaboration between a DC master trust and the LGPS could be a sign of things to come.

We hope you enjoy this issue.

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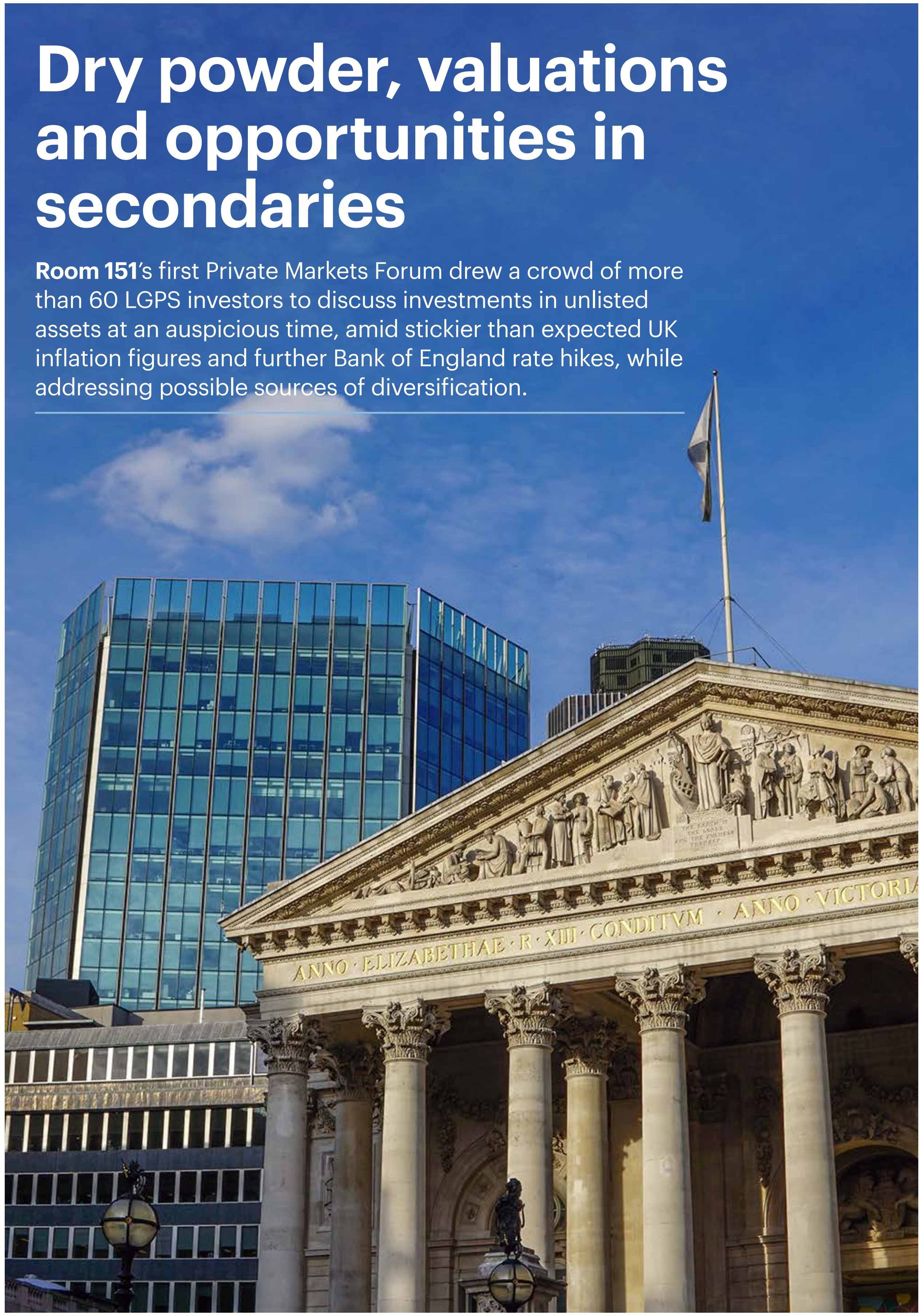
Dry powder, valuations and opportunities in secondaries

Room 151's first Private Markets Forum drew a crowd of more than 60 LGPS investors to discuss investments in unlisted assets at an auspicious time, amid stickier than expected UK inflation figures and further Bank of England rate hikes, while addressing possible sources of diversification.



Attendees at Room151's inaugural Private Markets Forum at the London Stock Exchange in late June were challenged to develop a forward-looking perspective on the asset class by Aoifinn Devitt, CIO at Moneta, who opened the event.

While Edward Palmer, partner, CIO and head of sustainability at AlphaReal, outlined in his keynote speech how the improved funding position of LGPS schemes due to the rise in gilt yields combined with persistently high inflation has led to a renewed focus on income generation.

He argued that in shifting their focus on secure income in private markets, LGPS investors could potentially establish a tool to meet liability cashflows whilst benefiting from inflation-linked returns.

Searching for solutions

Two members of the first discussion panel of the day said their authority's pension fund was looking to increase assets within private markets in the future.

"Within private markets, our focus will be more towards income generation," said Adil Manzoor, senior portfolio manager, alternatives and monitoring at Merseyside Pension Fund. "This is because we are a mature pension scheme, which means we have more pension payments going out than contributions coming in. So, we constantly need to look for yields and this presents a good opportunity."

David Spreckley, head of pensions and treasury at the London Borough of Barnet, said part of private market's appeal is the opportunity to achieve impact more directly than in listed markets. "I think we'll be searching more on the impact and net zero side within private markets, as this is an area where we are searching for the solutions. We're probably more likely to find those solutions in the private space opposed to the public space."

Leandros Kalisperas, chief investment officer at West Yorkshire Pension Fund, agreed that the private markets space allows pension funds to achieve impact, especially on the energy transition. However, he warned that there are risks associated with reallocating capital away from public markets and towards private markets.

Secondaries – concentrated buy side

The debate then moved to secondaries, which much like the broader asset class has seen a significant influx of assets. David Atterbury, managing director at HarbourVest, argued that the growth of the secondary market was in large part driven by the rapid growth of private markets, with assets then changing hands in the secondary markets. "There has been a real influx of opportunities," he said. But Atterbury also warned that on the buy-side, the market was heavily concentrated.

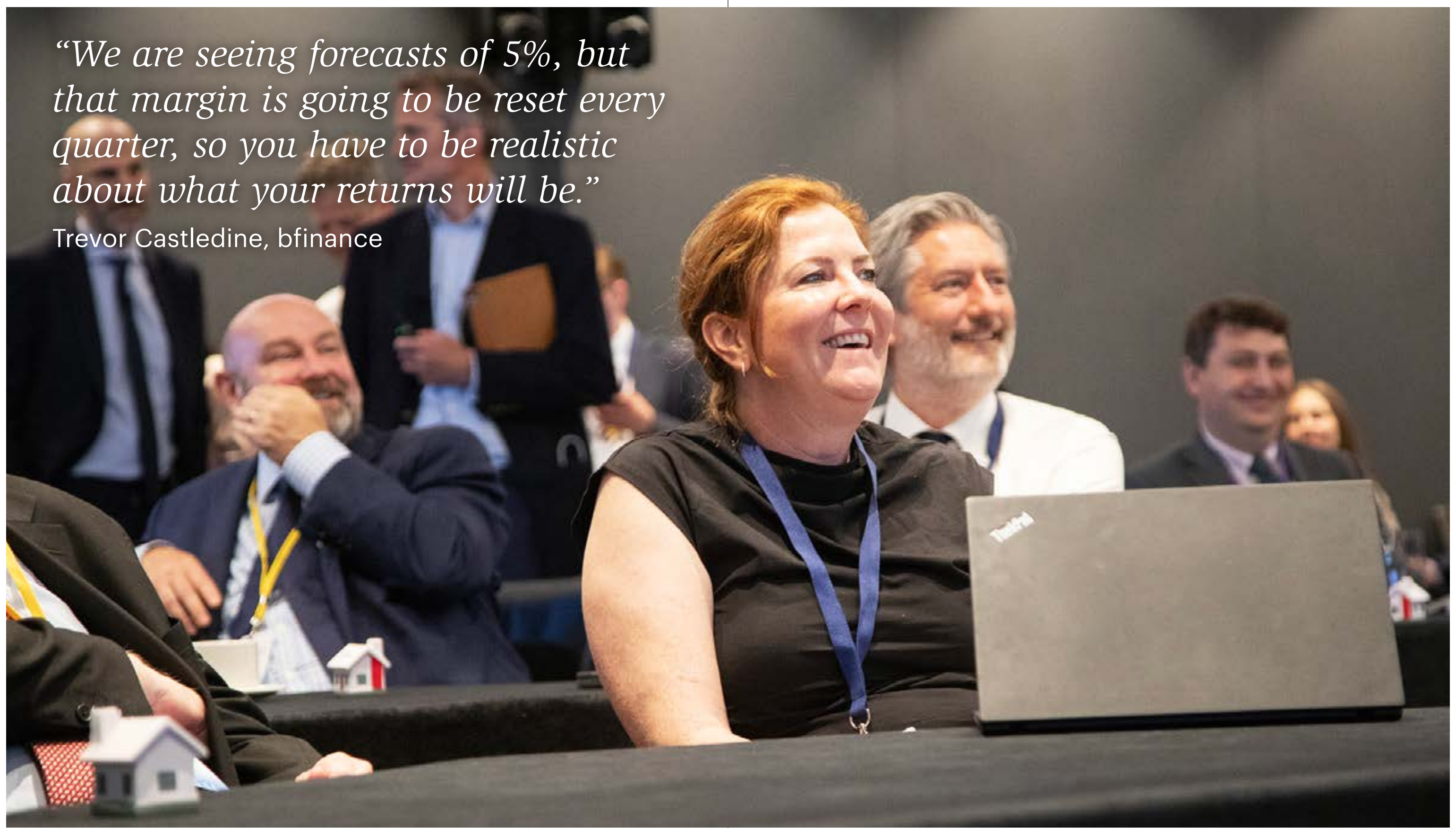
Adi Bhagwat principal, strategic equity at ICG (*above*), drilled down the debate with a focus on GP-led transactions, which have seen a near fivefold increase since 2017. This growth has been led by GP-led adoptions, Bhagwat said. "As this is still a relatively nascent market, there is insufficient GP-led capital relative to the opportunities," he added.

GP-led transactions can play a role in liquidity provision at a time when liquidity in LP-led transactions has somewhat dried up, due to LPs not selling assets, he argued.

But William Bourne, an independent advisor at Linchpin Advisory, drew the audience's attention to some of the potential challenges of investing in secondaries. He acknowledged that liquidity was a perk of the asset class but also warned that for investors who were selling, valuations could be a key challenge.

Private debt

Bruce Richards, CEO and chairman at Marathon Asset Management, kicked off the second round of debates on opportunities in private credit, with the argument that the hike in rates and equity market volatility introduced "a golden era of credit". Richards argued that the coming wave of defaults as a result of rate hikes represented an opportunity for private credit investors.



"We are seeing forecasts of 5%, but that margin is going to be reset every quarter, so you have to be realistic about what your returns will be."

Trevor Castledine, bfinance

Lei Lei, co-head European credit opportunities, alternatives at Ninety One, highlighted opportunities in asset-backed sponsorless markets which he described as "less competitive." While the distressed debt and sponsored direct lending market has dozens of players, the sponsorless market is dominated by five or six players, he said.

Trevor Castledine, managing director, private markets at bfinance and independent advisor South Yorkshire, responded by arguing that a lot of forecasts for credit margins had been optimistic. "We are seeing forecasts of 5%, but that margin is going to be reset every quarter, so you have to be realistic about what your returns will be," he emphasised.

Net zero opportunities

Another key panel session looked at the investment opportunities that arise from following a net zero investment strategy.

Barney Coles, managing director, co-head of clean energy at Capital Dynamics, highlighted the scale of the energy transition required and the importance of investing in infrastructure that corresponded to the UK's current use of energy use. He mentioned green hydrogen as one of the key investment opportunities in the renewable energy transition, though he acknowledged that its rollout might take longer than anticipated.

Mark Lyon, deputy CIO at Border to Coast, followed up on the theme of energy transition by outlining the key aspects of the pool's £12bn private market portfolio and its approach to reaching net zero. In addition to a £4bn renewable energy strategy, the pool last year launched a climate opportunities strategy which looks at investments to support the transition to a low carbon economy, including assets such as private debt and forestry.

Levelling up

A day of debates was wrapped up with one of the most hotly debated items on the LGPS's investment agenda: the government's levelling up agenda and the potential role of LGPS

investors in providing capital to fund the regeneration of historically underfunded areas in the UK.

George Graham, director of the South Yorkshire Pension Fund, noted that the concept of levelling up was not new but investments had to be beneficial to the fund. "The important thing is that this is investment, it might be investment with a purpose but it is still investment," he stressed. Consequently, it might be more labour intensive to implement but it should not be more risky than other assets, Graham emphasised.

> *"Investing in housing is not the panacea that people think it is."*
>
> Stephen Wild, OneSource

Stephen Wild, head of pensions & treasury at OneSource, outlined how Havering and Newham Council, the funds he worked with, have increasingly started to prioritise investments in social housing.

"Investing in housing is not the panacea that people think it is, particularly not at the social end, so we had to be familiar with not just the advantages but also the potential pitfalls," he said. The funds have now invested in projects which are aimed at helping people get out of temporary accommodation. He stressed that investors should always be mindful of local housing strategies in order to not drive up prices in the region.

Anne Copeland, co-head of social infrastructure at AlphaReal, stressed the opportunity of establishing strong governance standards with data and reporting having improved dramatically.

Speaking from an allocator perspective, Bola Tobun, treasury & pensions manager at the London Borough of Harrow, highlighted the challenges of sourcing suitable investments that align with the United Nation's Sustainable Development Goals.

She stressed that some smaller funds have been deterred by higher management fees in private markets, but that pools have helped to make the asset class more accessible. "It would be good to have public impact investments, if the government can help on that area and provide a fund structure we can all invest in, that would make our lives easier," she suggested.

Her suggestion was challenged by Graham: "The last thing we want is the government giving us some good ideas; that is unlikely to result in optimal outcomes. But I think pools can be part of the solution here."

The balance of power is moving in favour of lenders

The £55bn LGPS Pool Border to Coast, which manages the assets of 11 partner funds has more than 20% of its portfolio invested in private markets. We caught up with deputy CIO **Mark Lyon** to discuss his outlook for the sector.

Private markets play a big role in your investment portfolio: what sort of assets have you invested in?

Since we launched in May 2019, we have received £12bn in commitments from our partner funds. As of 31 March 2023, approximately £9bn has been committed to underlying investments and about £3.5bn has been drawn down.

Broken down by asset class, we have commitments of £3bn in private equity, £4.4bn in infrastructure, £3.2bn in private credit and £1.4bn in climate opportunities.

These commitments are determined by the partner funds in relation to their asset allocation decisions. Border to Coast does not make these asset allocation decisions.

To give some examples, in private equity, we have invested predominantly in buyout strategies with some exposure to growth, venture capital and opportunistic funds with notable sector exposures in technology and healthcare.

Our infrastructure assets include a mix of core, core plus and value add funds with significant sector exposures in renewables and digital infrastructure including a number of co-investments.

In the private credit segment, we have invested predominantly in senior direct lending with some exposure to real assets and opportunistic debt.

As for the climate opportunities strategy, this includes a mix of infrastructure, buyout, growth and credit funds with exposure to areas including traditional renewables, hydrogen, storage and grid infrastructure, energy efficiency and decarbonisation technologies.

Why is your private markets strategy broken down into different stages?

The typical private markets strategy will have a three-year investment period. But for a couple of reasons, our partner funds wanted the ability to make annual commitments. This is partly because some are new to the asset class and wanted to scale up quicker, but there were also those who have been in private markets for some time through legacy investments and were getting pretty sizeable distributions, so they wanted the flexibility to be able to make annual commitments to smooth out their allocation.

Fundamentally, to get a diversified portfolio, we deploy the capital from each capital raise over a 12 month period but seek to achieve such diversification over three years; that is where the series comes in. We want the visibility and the time to deploy our capital over a three-year investment period.

What role are co-investments playing in your broader private markets strategy?

We access co-investments in a number of ways. On the one hand, we have individual co-investments – we have reviewed around 100 opportunities, predominantly in infrastructure and completed six to date – these include a UK biomass plant, an infrastructure operator and developer with a global portfolio of assets, a US solar and battery storage project, a US telecoms tower portfolio, a US data centres portfolio, and a European waste investment.

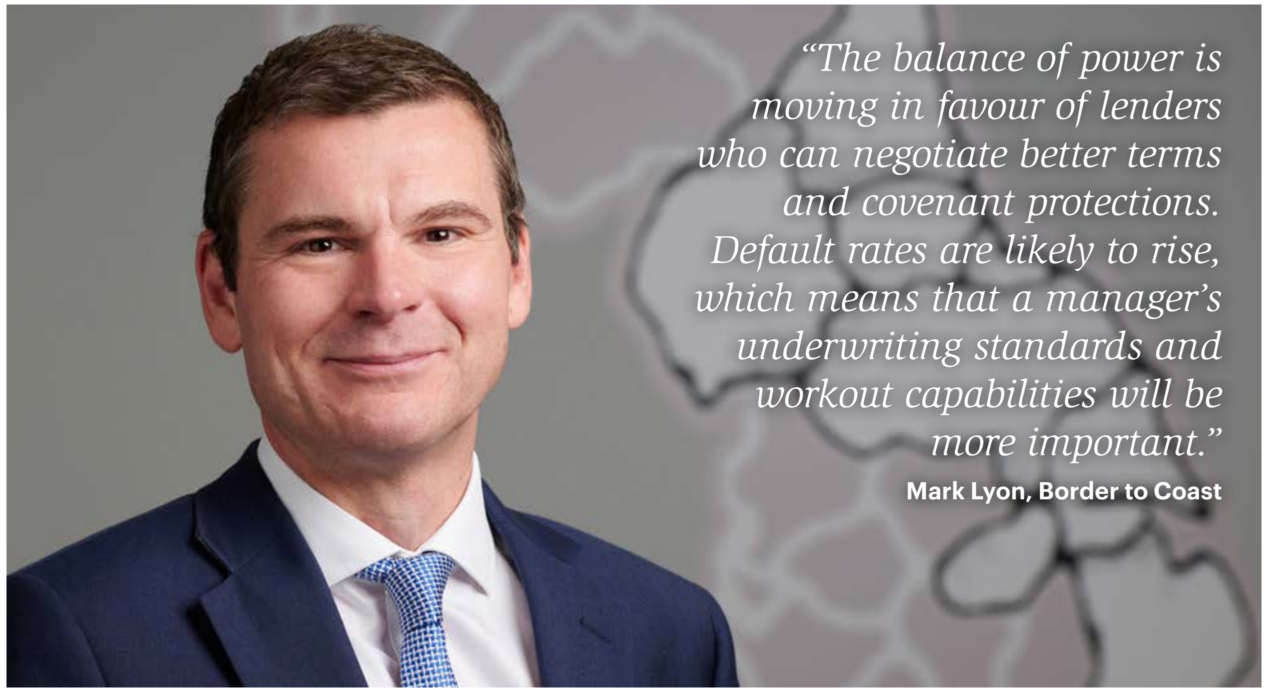
We also have a bespoke co-investment fund with an infrastructure manager which receives deal flow from its suite of funds – this is an arrangement we are looking to replicate with a couple of other key infrastructure relationships.

In addition, we also have co-investment funds in private equity as well as co-investment sidecars in private equity and private credit – these receive an overage from an investment in the main fund.

These investments serve to reduce the overall fee burden of the programme whilst providing suitable diversification across the portfolios and access to interesting opportunities offering attractive risk-adjusted returns.

How do you integrate ESG criteria in your private market strategy?

We integrate ESG and carbon considerations fully into our investment process. We issue an ESG due diligence questionnaire as part of our initial due diligence, which serves to understand how managers incorporate ESG into their process including investment



selection, value creation and reporting. This informs the completion of an ESG scorecard to assess the managers' strengths and weaknesses in this area. This is supplemented post-investment with an annual ESG questionnaire, regular review of the managers' ESG reporting, and interactions with managers when ESG issues arise.

We are very keen on improving the quality of ESG and carbon reporting and are members of the ESG Data Convergence Initiative, which we hope will become the industry standard approach to data provision in private markets.

With rates rising, where do you see growing opportunities and risks in private markets?
Within private equity, we are acutely aware of the impact of rising rates on entry and exit multiples, lower debt levels and higher costs of debt, on current return expectations. This environment should favour managers with operational value add capabilities and strong sourcing networks.

Within infrastructure, assets with visibility of returns through, for example, contractual arrangements would be expected to be more resilient.

Within private credit, the variable rate nature of direct lending is resulting in relatively attractive returns for new lending as base rates rise. The balance of power is moving in favour of lenders who can negotiate better terms and covenant protections. Default rates are likely to rise, which means that a manager's underwriting standards and workout capabilities will be more important.

Within our climate opportunities fund, there are a wide range of opportunities in established and new technologies supported by an increasing investor focus on climate transition as more make net zero commitments, as well as significant incentive packages such as the EU Green Deal and US Inflation Reduction Act.

How are your partner funds adjusting their strategic asset allocation based on that?
We have seen our partner funds increase their exposure to private credit, possibly due to improved funding ratios and a desire to improve income as the funds mature, but also possibly due to the more attractive environment with higher rates and higher potential returns.

We also expect them to increase their exposure to our climate opportunities fund as more and more of them make net zero commitments.

Investing for income, inflation and impact

Adrian D'Enrico, fund manager at Edmond de Rothschild REIM, outlines how investments in affordable housing can deliver stable, inflation adjusted income streams.

A growing population is placing increasing pressure on the UK housing market, exacerbating a pre-existing shortfall of both private and affordable homes. Over 123,000 children do not sleep in a permanent bed each night[1] and more than 1.2 million households are on local authority waiting lists[2] – equivalent to the population of Manchester, Liverpool and Cardiff combined. The scale of the problem is self-evident.

The solution? We need to build more homes. Across all tenures. Of the 300-400,000 new homes estimated to be required to meet demand each year, around 150,000 should be affordable. Yet over the last 10 years, new affordable housing completions have averaged just over 50,000 – a third of the required amount[3] – despite considerable efforts to encourage investment, including £7.4bn of grant funding through the Affordable Housing Programme. The shortfall of investment is material – estimated at almost £17bn each year[4]. This is a scale, multi-year opportunity for investors.

Housing associations and other traditional providers of affordable housing are facing competing pressures for available capital – fire safety remediation costs, maintenance and improvement works to meet new consumer standards and refurbishments to reach energy efficiency requirements (both EPC regulations and net zero ambitions). These pressures are restricting development, with more than half of England's housing associations having halved forecast completions[5]. Meanwhile, demand continues to rise, driven by demographic forces and the fallout of the cost-of-living crisis. New sources of capital are required – at speed and at scale.

Public sector equity investment into social and affordable housing has increased materially over recent years, from virtually zero in 2012 to £3.8bn in 2021[6]. But further support is needed – the sector demands more, and for those investors willing to commit capital to acquire and develop new, affordable homes, there are three attractive benefits: income, inflation-alignment and impact.

Dependable income

With a supply shortfall and durable, demographically-driven demand, affordable housing can deliver long-term, dependable

income, in many instances supported by public sector funding. Relative to economically-driven, cyclical sectors, occupancy and rental income streams in housing are largely insulated from external shocks. Rents continued to be collected in full during the Covid-19 pandemic and occupancy saw little variation – void rates remain low, at just 1.2% across the 12 members of the G15[7], comparing favourably to the UK commercial property market where vacancy rates have risen to 7.6%[8]. Dependable income with low volatility is a valuable diversifier in investor allocations.

Inflation alignment

Not only is the income resilient, it is also inflation aligned. Social housing rents are permitted to increase by CPI+1% annually under the current rent settlement. Given the recent upward spike in CPI inflation (reaching 10.1% in September 2022 which would have predicated an 11.1% rise in 2023), a consultation was launched by the government[9] to control rising rental costs, seeking to cap uplifts. Following the consultation, in April 2023 a 7% cap was implemented for one year – a positive outcome and maintaining the attractiveness of sector relative to the wider long income market. Looking at other real estate assets offering long-term, inflation-aligned income, more than 90% of all RPI and CPI-linked leases are capped at 5% or below[10]. Robust income, growing with inflation, can help match long-term liabilities.

Positive impact

Whilst the financial characteristics alone are attractive, the sector can also provide tangible, positive social impacts for residents and communities in which homes are built. These impacts can deliver on investors' impact or responsible investment ambitions – or obligations. The UK government has, for example, targeted LGPS' participation in 'levelling up' through the allocation of 5% of their assets in 'projects which support local areas'. Affordable housing is an almost perfect fit for this ambition and the LGPS 5% allocation alone could provide £16bn in new, much-needed dry powder.

The opportunity

Affordable housing can deliver attractive benefits to investors: durable income with public-sector backing, inflation-alignment, and tangible, positive social impacts for residents and communities. Underpinned by demographic-driven demand, occupational performance is well insulated from economic cycles, with investments exhibiting a low correlation with other real estate sectors and the wider economy[11]. A strong diversifier, affordable housing offers a scale opportunity to invest in a regulated sector, achieving both dependable, long-term financial returns and positive social impact – benefiting both stakeholders and the residents alike.

1 Shelter, press release, January 2023 (England only)
2 DLUHC, Live Table 600 (end-2022) (England only)
3 DLUHC, Live Table 1000 (end-2022) (England only)
4 House of Commons Library, Tackling the Under-supply of Housing, February 2022
5 Regulator of Social Housing, Quarterly Survey Q3 2022 (March 2023)
6 Big Society Capital, Mapping the market, November 2022
7 G15 Housing Associations annual reports & accounts, 2021/22 (EdR calculation, March 2023)
8 MSCI, UK Annual Property Index 2022 (financial vacancy)
9 DLUHC, press release, August 2022
10 CBRE, UK Long Income Index, Q1 2022
11 Impact Investing Institute, "Is there an investment case for social and affordable housing in the UK?", October 2021

Investing in infrastructure

The UK government has stated its desire to see more institutional cash going into UK infrastructure. What are the opportunities, and are there enough of them? **Jason Holland** seeks the case for and against investing at home.

Investing in the UK has historically been relatively secure given the country's legal framework and the systems that are in place – along with the fact that the government rarely intervenes substantially. So it is perhaps surprising to hear talk of possible government intervention as it aggressively promotes pension fund investment in UK infrastructure.

The reality of the situation is rather different, according to consultant John Ralfe. "It is difficult for the government to force pension schemes to do anything," he says, noting that it is a matter of law whether "200 years of trust laws" could be overridden. "There would be legal cases for at least five years," he expects, making intervention "unthinkable".

Instead, the government must take a "softly, softly" approach, he says, with local government pension schemes ultimately taking the lead.

Ralfe has argued for local government pension funds to consider reducing their overseas investments and instead look for opportunities closer to home, expressing his "genuine surprise" that so much is invested in the US. However, looking at infrastructure specifically, he questions whether there are enough "genuine projects that are sufficiently advanced, where the government has taken on the early risk".

Although there will be some, he says, and especially small-scale local projects, he is wary of infrastructure "start-up" projects, with HS2 an example. "Pension schemes shouldn't be interested in holes in the ground," he says. "What are the mature infrastructure projects?"

Attracting investment

The UK Infrastructure Bank (UKIB), a government-owned policy bank focused on increasing infrastructure investment across the UK, represents one means of possible progress. Seeded with £22bn of financing capacity, UKIB aims to partner with the private sector and local government to increase infrastructure investment in the UK, with objectives of tackling climate change and supporting regional and local economic growth.

"We have a role to play in attracting investment into UK infrastructure projects," says Ian Brown, UKIB's head of banking and investments. "Our presence in a deal can help instil confidence with potential investors and we can act as a cornerstone investor in more challenging markets. Through appropriate structuring or the use of our guarantee, we are also able to improve the credit rating of transactions to make them eligible for institutional investment."

Brown says UKIB's risk appetite is different to that of commercial institutions "because we are focused on achieving strategic policy objectives as well as delivering a positive financial return". This enables UKIB "to support sectors to move away from subsidy, scale up existing sectors and support emerging financing markets and nascent technology, whilst continuing to crowd in private finance".

He adds: "Through our local authority lending and advisory service, we are supporting local authorities, who are at the forefront of driving regional and local economic growth and tackling climate change, through their ambitious infrastructure projects."

As well as "exciting opportunities" in the transport, digital, water and waste sectors, Brown points to the clean energy sector as a major area of opportunity. "Recently, for example, the bank announced it has committed £50m to the Port of Tyne's regeneration and expansion plans," he says. "The bank's financing will enable regeneration and redevelopment of the land that will provide a base for the growing number of green industries in the area, including offshore wind, which supports the UK's transition to net zero and long-term energy security ambitions."

Capital Dynamics, as a renewable energy infrastructure specialist, sees plenty of opportunity in this area, too. "To meet its net zero targets, the UK will need to almost double its renewable energy capacity by the end of this decade, and attract £70bn of funding to do that. That has led the government to commit to a more supportive policy agenda," says Barney Coles, co-head of clean energy. Renewables Contract for Differences auctions add further positive momentum, he notes.

"These initiatives provide investors with cash-flow stability, and there are commitments to upgrades in grid infrastructure that will facilitate a more timely delivery of green generation capacity," says Coles. While he acknowledges that today there is a relative scarcity of projects, he thinks the future looks positive.

"After the next general election, we expect a relaxing of planning rules to enable renewables projects, given all political parties have signalled their commitment to this," he explains. "New policies will result in a lot more opportunities.

"After the next general election, we expect a relaxing of planning rules to enable renewables projects, given all political parties have signalled their commitment to this."

Barney Coles, Capital Dynamics

The UK Infrastructure Bank recently announced it has committed £50m to the Port of Tyne's regeneration and expansion plans

Image: Port of Tyne

In addition, many of the world's largest corporations have operational presence in the UK, and they all want to decarbonise, and therefore are going out and seeking long-term arrangements to buy renewable power directly from renewable energy projects. That depth in the UK is unparalleled. And while there is asset scarcity, those investors with proprietary access to projects are in a very strong position."

Long-term cashflows

Investment manager Quinbrook expects higher capital allocations from LGPS to UK-focused strategies as a result of the government's levelling up agenda and post-Brexit inspired focus on 'home grown' investments, especially in new infrastructure.

Rosalind Smith-Maxwell, Quinbrook's senior vice president, comments: "Quinbrook considers that the UK 'net zero' transformation offers unprecedented investment opportunities, especially in new infrastructure assets.

"Achieving 'net zero' is expected to require substantial investment (£2.7tn of investment to 2035, and £375bn to decarbonise power and grid alone) in the planning, development, construction and commissioning of new infrastructure solutions which in turn have the potential to create and support fair and sustainable jobs, directly benefit local communities, in particular regional communities, drive business stimulus and rapidly decarbonise the UK economy and society. Many of these new investments offer long term cashflows and Quinbrook considers these to be attractive opportunities."

Smith-Maxwell cites diverse initiatives such as National Grid's Pathfinder programme, the Contract for Differences programme, and the Capacity Market. "Many new build projects in the UK are able to secure long term revenues with uncapped indexation to CPI from availability and generation services," she says. "Further, UK power infrastructure assets have diversifier benefits to assets which are strongly correlated to GDP. Together this makes select types of UK infrastructure highly attractive investments even when evaluated in a global context."

Indeed, Coles thinks that the UK compares extremely favourably with certain established parts of continental Europe. "We consider the Eurozone, the UK and potentially the US as the most mature markets globally for renewables infrastructure. The UK ticks a number of boxes – returns on offer are typically higher than in markets such as Germany and France where there is excessive competition from local institutional capital looking for local investments, and where European base interest rates have historically been a lot lower than in the UK.

"In addition, we believe the risk-return profile for UK renewable investments is more attractive, particularly given the wide availability of 'pay-as-produced' power offtake contracts being offered by global organisations operating locally, rather than the inherently more risky 'baseload volume obligation' contracts on offer in areas such as the Nordic region."

Smith-Maxwell adds: "The UK recently re-affirmed its position as fourth in EY's renewable energy country attractive index which rates all countries on their relative investment attraction. Whilst the UK is a smaller market than Europe or the US for example, it does have aggressive decarbonisation targets."

"The UK recently re-affirmed its position as fourth in EY's renewable energy country attractive index. Whilst the UK is a smaller market than Europe or the US, it does have aggressive decarbonisation targets."

Rosalind Smith-Maxwell, Quinbrook

Institutional investors such as the LGPS typically have exposure to both global and UK focused investment strategies, and the various opportunities are not mutually exclusive, points out Smith-Maxwell. "There is ample opportunity to allocate more capital to UK investments yet still retain geographic diversification in overall portfolios," she says. "The UK is able to offer investors access to a holistic approach to the energy transition, with opportunities in grid support, storage and generation all capable of being supported by long term inflation linked contracts."

Looking to the future

On the outlook for the case for investing at home, Smith-Maxwell thinks that while the overall opportunity will be "enduring", the next 3-5 years "will be a critical phase and should reward investors who address the UK's urgent supply need for low cost and carbon free renewable power".

She adds: "The outcomes are expected to be improved power grid reliability, efficiency, and stability, driving innovation and growth in much needed technological advances in energy asset management, and building long-term, sustainable solutions focused on creating positive impacts to stakeholders across the full asset and business lives."

Ralfe thinks that while there are opportunities for the LGPS, limitations remain. Pools are all trying to find the right opportunities, and it is "the same clever people trying to get the same clever deal, and there are not too many deals around".

Ben Crawfurd-Porter, LGPS investment manager at Ruffer, also strikes a cautious tone. He notes that while valuations of long-term UK infrastructure assets have been supported by "relatively stable long-term discount rates, despite rising inflation", should inflation begin to "look entrenched and central banks lose credibility, there is a risk that longer term inflation expectations rise, and interest rates remain higher for longer. This would increase the discount rate and weigh on previously robust UK infrastructure valuations."

Nevertheless, one of the longer-term consequences of the LDI crisis last year "is likely to be an increased supply of private market – including UK infrastructure – investment opportunities available in the secondary market as corporate DB pension schemes de-risk and reduce their illiquid positions". The LGPS "should be well positioned to capitalise on this opportunity, if they can be nimble enough to take advantage", he notes.

But LGPS funds should be "mindful" of liquidity risks when committing to long-term infrastructure projects, he adds. "Capital calls can be lumpy, irregular and delayed. Thought should be given on appropriate places to hold funds being transferred from equities to private markets."

There are prominent examples of infrastructure investments gone wrong, as the negative media headlines for UK water companies highlight. In this case, private equity’s tendency to accelerate the pace of gearing at the expense of sustainable long-term investments has generated scandals around sewage spills and environmental pollution. It has also left investors exposed to potentially hefty fines. This is likely to be a real concern for investors such as GLIL, which owns a 7.5% stake in Anglian Water. For private equity investors in UK infrastructure, significant engagement and stewardship efforts will be required in order to avoid scheme members being exposed to regulatory risks.

Another risk is rising interest rates, particularly for infrastructure firms that are heavily geared and are now struggling to refinance, as the case of Thames Water illustrates. The true scale of this problem will only be revealed over time when current credit agreements expire. But there is a flipside to that. For investors with a long-term investment horizon and sufficient cash reserves, struggles to refinance might mean that infrastructure assets become more affordable, if investors are willing to stomach the risks.

Keen appetite

Despite these potential risks, UKIB’s Brown says UK investors are continuing to show a “keen appetite” for domestic infrastructure, “as demonstrated by the NextPower UK ESG Solar Fund that UKIB cornerstoned and which has, so far, won the support of four LGPS pools”.

He adds: “It is also encouraging to see LGPS-owned GLIL Infrastructure continue to grow to £3.6bn of commitments, with a UK-focused mandate and investors such as Railpen transition to more direct strategies.

“Those that have invested in infrastructure that delivers explicit inflation protection will have been vindicated in current market conditions. After well over a decade of benign inflation, the recent spike will have been beneficial to revenues at a time when costs and borrowing costs are rising, cushioning the valuation of portfolios.”

“After well over a decade of benign inflation, the recent spike will have been beneficial to revenues at a time when costs and borrowing costs are rising, cushioning the valuation of portfolios.”

Ian Brown, UK Infrastructure Bank

Coles says Capital Dynamics, too, has been “pleasantly surprised” by the level of appetite from the LGPS community investing in its UK funds. “There appears to be a big push for the LGPS to invest in the UK. Given its net zero commitments, the UK government is doing its best to incentivise and encourage funding from the LGPS in these areas. We have positioned ourselves as a manager to facilitate that in UK renewables in particular, given our access to high quality proprietary projects across the country.

“Clearly renewable energy infrastructure is very much decentralised given its link to underlying solar or wind resource – often physically located in more remote places in the UK – and with this it brings significant investment in local communities and local skilled jobs; benefits which wouldn’t otherwise be there.

“Renewables is a good way for LGPS investors to tick those boxes. Returns on offer are still extremely attractive if deployed smartly, using the right investment structure, and with a clear and visible deal pipeline that will be delivered quickly and efficiently whilst supported by the highest quality contracts. It’s all about the package.”

Perhaps the strongest appeal of UK infrastructure, beyond returns and diversification benefits, remains the fact that investing in local assets is a strong story to take back to scheme members. “Our scheme members are very connected to our places and therefore, doing good things in these places is important to us,” says George Graham, investment director at South Yorkshire Pension fund.

So with government encouragement rather than intervention, UK infrastructure presents opportunities for institutional investors to seriously consider – now and in the near future.

No shortage of opportunities

Room151 speaks to **Alina Osorio**, president at Fiera Infrastructure, about the firm's approach to investing in infrastructure projects that are driving the new economy.

Can you tell us more about the composition of your infrastructure investment portfolio?
We invest in what we call "new economy, essential infrastructure," long-life assets that are necessary for our economies to function. We do this through our open-ended fund, which invests globally in infrastructure.

We focus on mid-market assets that are on the lower end risk spectrum, assets that society needs to function every day.

Your portfolio focuses on what you call the "new economy". Can you give examples of that?
Over the past seven years we have built our portfolio to be well-diversified across sub-sectors and geographies. We focus on three investment themes – energy transition, social and digital (connectivity). More than half of our portfolio is invested in climate-related infrastructure that supports energy transition and the move towards a circular economy. About 30% is invested in digital infrastructure, and in particular fibre networks. The remainder focuses on social infrastructure and transportation.

In terms of geography, we invest across OECD countries, as they provide a stable legal and fiscal framework for investment. Around 45% of our portfolio is in the UK, the rest is in the US, Europe and Canada.

Can you elaborate to what extent your portfolio is on the lower end of the risk spectrum?
Infrastructure can mean different things to different people, with some preferring to participate up or down the risk spectrum. Consistent with our long-term approach, more than 90% of our investments are contracted. We always think about the revenue line as driving the risk. Having a high proportion of contracted revenues ensures the visibility and stability of the cash flows and, ultimately, portfolio returns.

In the LGPS space, are you mainly working with pools or funds?
We work with both pools and funds. We are seeing allocations to infrastructure from individual funds, particularly when a pool does not offer what the fund is looking for. Our focus on new economy infrastructure – energy transition, social and digital infrastructure, with no fossil fuels in our portfolio helps funds and pools meet their net zero targets.

Where would an infrastructure allocation sit in the typical LGPS portfolio, would it be part of growth or matching assets?
We understand the investment consultant community tends to classify infrastructure as an income asset given one of the main benefits of infrastructure is income, and we would agree with that classification. LGPS schemes have large monthly commitments to pay pensioners, and as such are looking for income-generative assets. Another attraction of infrastructure is that it has strong inflation linkage. A high proportion of infrastructure assets are contracted to increase with inflation, which is particularly beneficial in today's inflationary environment. Members' benefits are linked to CPI, so infrastructure has a natural alignment to the LGPS. LGPS also tend to like the long-term nature of infrastructure, which is well aligned to their own long-term liabilities. And lastly, infrastructure typically has low correlation to traditional asset classes.

How does Fiera Infrastructure's investment strategy inform your approach to ESG?
We have a strong ESG approach. As investors, we are looking to strike a balance between our fiduciary obligation as stewards of capital and moving ESG forward in our investment activity. In practical terms, this means that we integrate ESG into our deals, from origination to due diligence, into asset management and into our team's compensation.

When we look at originating transactions, the original screening that we do for prospective deals, the due diligence that follows and the transaction and execution documents all identify ESG factors and map out ESG considerations for the prospective investment.

Once deals happen, we go into asset management mode and work closely with the management team to implement our ESG programme. This includes ensuring the necessary reporting requirements are in place, monitoring ongoing compliance with our ESG standards, and looking for opportunities to advance the ESG agenda at the investment. This is not about box ticking, this is about taking stock and driving improvements.

We are evaluated every year through GRESB assessments and our fund most recently received a score of 90 and a 4-star rating. We are a signatory of the PRI and the Net Zero Asset Managers Initiative through Fiera Capital, and we are proactively working toward our goal of reaching net zero GHG emissions by 2050 by committing to an interim target of 50% reduction by 2030. And our fund is classified as an Article 8 vehicle under the EU's SFDR.

How does your approach to governance differ from that in listed markets?
The difference between public market investing and privates is that we have a controlling equity stake. With that comes benefits of governance, which allows us to actively manage our investments. We're very hands on with our assets. We sit on boards and set budgets, business plans and compensation.

For us, asset management is constant. We talk to our management teams at least weekly to be able to monitor the business from an operational, financial and ESG perspective. It is very laborious, but that is the only way to get results and enhance value.

Finally, where do you see the major opportunities in infrastructure investing?
Very often, infrastructure is dominated by large-cap strategies and large GPs. We think that the mid-market is an interesting space to be in, with an abundance of opportunities. Many are relationship-based and are coming from within the portfolio, and we'll continue to focus on our three main themes of energy transition, digital and social infrastructure.

Energy transition is an enormous opportunity. Wind and hydro are obviously part of that, but we also have investments in smaller-scale residential rooftop solar, providing solar-generated electricity to social housing, and community solar, bringing the benefits of solar-generated electricity to low- to moderate-income customers. In digital, we are seeing a great need to continue to support fibre connectivity by expanding and deepening networks. And in social infrastructure, the tremendous opportunity driven by the need to support continued population growth is something we have been addressing through our investments in UK and Canadian social housing.

GLIL – new bridges

With the government pushing for more consolidation and infrastructure investments across the LGPS, DC and corporate DB, could the collaboration between Nest and GLIL be a sign of things to come?

GLIL, the £3.6bn infrastructure platform for the LGPS, is often heralded as an example of successful cross-pool collaboration. Since its inception in 2015, it has invested more than £2bn in UK infrastructure projects. But two years ago, something rather unusual happened.

Nest, the £30bn government-backed DC master trust, announced plans to invest £3bn in infrastructure, including a mandate with GLIL. On the face of it, the story of Nest's investment in GLIL is straightforward, as Stephen O'Neill, head of private markets at Nest explains. "In 2021, we had permission from the investment committee to add infrastructure to our investment universe. We weren't trying to market-time, but having onboarded private credit beforehand, we decided to move to infrastructure equity because we had sufficient interest from a few managers and thought we could probably get something at a decent price," he explains.

"GLIL won our lot as UK core manager, in part because of the alignment of interest with the institutional LGPS money, also because of the commercial attractiveness of the LGPS pricing model which is a bit different to most managers. We also liked the assets they had in their portfolios, the values of their investment thesis were born out by their holdings."

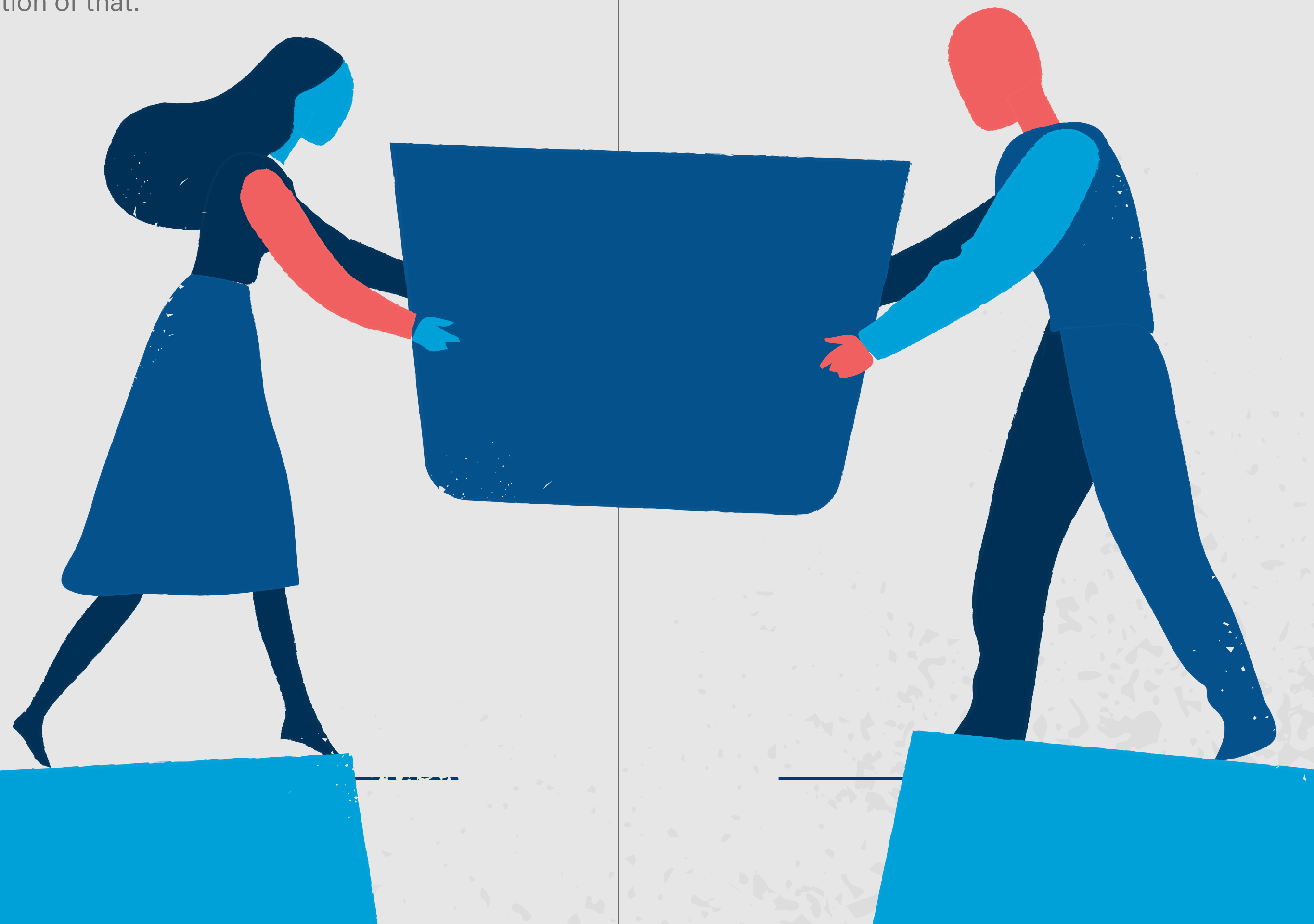
Liquidity and cost cap challenges

From GLIL's point of view, the collaboration with a DC scheme was an "interesting opportunity to test our approach" as chief operating officer Ted Frith describes it. Albeit one that comes with its own challenges. "The DC world is quite different from the LGPS world, which are obviously fully funded DB schemes. The two most obvious challenges are liquidity and the cost cap," explains Frith.

As with any capital allocation, the onus is on the DC provider, in this case Nest, to meet these challenges. Frith emphasised that the pricing structure in GLIL is the same for all members: "we are not giving anyone a better deal than everybody else gets." But despite these constraints, GLIL's terms did not exceed the charge cap threshold.

"This comes about for two reasons, we are a profit-for-members partnership, and any surplus is retained by the fund and distributed to the members. We're not paying huge management fees, carried interest or performance fees to investment managers," Frith explains.

"What we do is all about accruing the benefits of pooling of capital and human resources which goes back to the origins of what George Osborne was talking about back in 2015 when he was putting pooling in place. We are a manifestation of that."



While this is not directly his turf, Frith expresses surprise at the government's decision to effectively remove the DC charge cap. "It's clearly possible for private market managers to operate underneath the cap, and Nest is a great example of being able to operate within that constraint," he stresses.

On the requirement of daily pricing, Frith is also keen to emphasise that GLIL does not offer Nest or any other member any unique liquidity terms. "We're not making any concessions in the fund to help any one investor manage their liquidity. That's important for all of our investors; giving preferential liquidity to certain investors over others would put everyone in a bad place," he says.

In practice, this means that Nest and GLIL have an understanding that they do not receive a different price every day. This information is then adjusted by GLIL on a quarterly basis, and the risk of these infrastructure valuations is then managed in-house by Nest.

Valuation risks

This could be a potential stumbling block for other master trusts. While they might be able to meet the cost requirements, not every master trust might be willing to take on the risk of managing valuations.

In practice, liquidity has been a relatively marginal concern for master trusts like Nest, which benefit from a much younger membership structure. Nest receives about £500m a month in cashflows from member contributions, which make liquidity a less pressing issue.

If anything, deployment of cash in private markets could become a bigger headache. Nest has committed to invest around 5% of its portfolio in infrastructure. Added to that comes the more recent backing of the Mansion House Pact, which will see Nest put aside 5% of its portfolio to private equity investment. The master trust currently sits on around £50m of dry powder and is keen to prevent further buildup, O'Neill says.

But with £500m in cash coming in monthly and the master trust expected to hit £100bn in assets by the end of the decade, the absolute size of Nest's infrastructure allocation is set to rise to at least £5bn by 2030.

Not all of these assets are deployed with GLIL. Nest has appointed a number of infrastructure managers with others offering access to a more globally diversified portfolio and to the renewable energy sector, O'Neill says.

Room for growth

Frith sees potential for further collaboration with investors beyond the LGPS. "From where I sit, we are deploying capital of our existing members, including Nest, we still have some capital to deploy. But in the next six to 12 months, I would foresee that we will be opening the fund to new members. And I am very interested in talking to other master trusts," he adds.

"To be honest, we've been relaxed about looking for new members because we haven't needed the capital. This is in part due to the unique nature of private markets, where the deployment of capital can take time, and the fact that our members have had a lot of capital to deploy."

Meanwhile, Nest also remains open to increasing its overall infrastructure allocation. "Our overall capacity for illiquidity could increase and when that happens, naturally our total exposure to infrastructure could increase as well," O'Neill predicts.

Mid-market, sponsorless borrowers: an untapped opportunity set

The sponsorless market – borrowers owned by entrepreneurs, families and shareholders other than private equity funds – is a compelling one for investors, say **Lei Lei** and **Chris Rust**, co-heads European credit opportunities at global investment manager Ninety One.

A combination of structural and cyclical factors is producing a compelling opportunity for investors who are looking to enhance portfolio diversification and earn meaningful investment returns. The demand for capital from Europe's SME sector is greater than ever before.

A gap in the market

There is a growing need for private credit in the underdeveloped European market, where banks continue to retreat from lending and mid-sized firms seek flexible financing solutions.

The ongoing retrenchment of European banks is contributing to an estimated €400 billion[1] funding gap in the European SME market. Meanwhile, the cyclical backdrop of slowing economic growth and rising inflation pressure is driving up demand for finance across the corporate sector. Many SMEs require flexible financing for expansion and other activities. This creates a gap in the market for investors who can provide bespoke capital solutions to performing mid-market 'sponsorless' borrowers. The term 'sponsorless' refers to borrowers owned by entrepreneurs, families and shareholders other than private equity funds.

An uncrowded market

The need for specialist credit skills and a differentiated approach to origination creates high barriers to entry and this increases the potential for compelling risk-adjusted returns.

To tap into the sponsorless market, private credit managers need deep origination networks to uncover opportunities across a wide range of countries and sectors – this means a focus on smaller advisors and independent introducers located in second and third tier cities who have strong relationships with locally based borrowers.

By sourcing off-market deals rather than partaking in competitive processes, lenders such as Ninety One can also command higher fees and better lending terms. And borrowers are willing to pay a premium cost of capital for a flexible, bespoke approach and execution speed. Debt structuring expertise is also vital for compelling risk-adjusted return outcomes and to allow a strong focus on downside protection. We think that a private equity-style approach to underwriting and managing downside risk is the best approach.

Presenting an attractive risk/return profile

Today, Europe is home to many small-to medium companies (with an enterprise value typically ranging from €50 million to €200 million) spanning founder-led businesses, entrepreneurs, and medium-sized corporates.

Among these are some really robust businesses that need capital to fund their expansion or for other purposes such as performing shareholder buyouts and refinancing their operations, but have limited avenues open to them, as outlined above.

Private credit managers with the right expertise can offer tailored private financings to these sponsorless borrowers and provide an attractive alternative to dilutive equity and restrictive bank debt; this may be the only option for some borrowers that are too small to access capital markets.

As many of these borrowers are asset-rich, lenders can ensure that their loans are fully asset-backed to ensure a compelling risk/reward profile – this is particularly important given the challenging macro backdrop facing companies today. However, a careful approach to risk management is key.

While sponsor-focused direct lending strategies typically target gross returns of high single digits, the uncrowded European sponsorless market typically targets gross returns in the mid-teens.

A sweet spot in private debt markets

There are many more potential sponsorless borrowers in Europe than there are sponsor-backed. This means that the opportunity set for investors is much greater, allowing the lender to be highly selective and command attractive terms and lender protection.

Many sponsor-backed companies take on levered debt to maximise equity returns for their private equity owners – one of their key objectives. In contrast, sponsorless borrowers – firms managed by their entrepreneurial owners – in general require capital to grow their company and generate returns to repay their debt. Many sponsorless loans tend to generate more attractive risk-adjusted returns, due to lower loan-to-value (LTV) ratios and stronger lender protection.

[1] €400 billion estimated funding gap figure from Euler Hermes, April 2019