Item 2(a)

7th September 2022

Glasgow City Council

Strathclyde Pension Fund Committee

Report by Richard McIndoe, Director of Strathclyde Fund

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Direct Impact Portfolio (DIP)
Investment Proposal – Beechbrook UK SME Credit Fund III

Purpose of Report:

To set out a proposal for an investment of £40m within DIP.

Recommendations:

The Committee is asked to **APPROVE** an investment of £40m in Beechbrook UK SME Credit Fund III by DIP.

Ward No(s): Citywide: ✓

Local member(s) advised: Yes ☐ No ☐ consulted: Yes ☐ No ☐

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1 Background

1.1 Portfolio Establishment

In December 2009, the Strathclyde Pension Fund Committee agreed to establish a New Opportunities Portfolio (NOP) with a broad remit to invest in assets for which there was an attractive investment case but to which the current structure did not provide access.

1.2 Review

The NOP strategy has been subject to 3-yearly reviews with the name changing to the Direct Investment Portfolio in 2015. The most recent review was concluded in November 2021. This made no change to the objectives, structure, overall size parameters, risk and return parameters, or governance structure, but did result in an increase in the individual investment size parameters and a further name change to the Direct Impact Portfolio (DIP).

1.3 Implementation Framework

DIP investment proposals are assessed on their own merits within an agreed implementation framework based on SPF's overall risk-return objectives and specific DIP parameters.

The framework agreed at the 2021 review is summarised below.

Direct Impact Portfolio	
Objectives	Primary objective identical to overall SPF investment objective. Secondary objective of adding value through investments with a positive local, economic or ESG (environmental, social, governance) impact.
Strategy & Structure	In line with SPF risk-return framework but focused on the UK and the Equity, Long Term Enhanced Yield and Short Term Enhanced Yield asset categories.
Risk and Return	Portfolio benchmark return of **CPI +3% p.a.** Individual risk and return objectives for each investment.
Capacity	Target allocation of **5%** of total Fund (based on Net Asset Values). Range of **2.5**% to **7.5%** of total Fund.
Investment Size	Target: **£30m** to **£100m** Minimum: **£20m** Maximum: greater of **£250m** or **1%** of Total Fund Value
Decision Making	3 stage process with review and satisfactory due diligence by officers, followed by a presentation to the Sounding Board before a proposal is taken to Committee for approval subject to completion of legal documentation.
Monitoring	Includes individual investment reports, participation in advisory boards, and a quarterly DIP monitoring report which is reviewed by the Fund's Investment Advisory Panel.
Co-investment	Existing co-investment programme should be extended in order to maximise its effectiveness, subject to development of a detailed proposal

The following proposal has been assessed using this framework and has been reviewed by the SPF Committee Sounding Board.

2 New Investment Proposal

2.1 Key Terms

Name	**Beechbrook UK SME Credit III LP**
Investment vehicle	English Limited Partnership
Manager	Beechbrook Capital LLP
Sector	Credit
Investment objective	To provide loans to UK regional businesses in the lower mid-market segment
Term	8 years (3-year Investment Period plus 5-year harvest period)
Target size	£300m (Hard Cap £400m)
Proposed DIP investment	£40m
Target return	Internal rate of return (IRR) of 8%-9% (Net)

2.2 Investment Summary

Beechbrook Capital is an investment management firm founded in 2008 by two experienced credit market professionals, Paul Shea and Nick Fenn. Beechbrook focuses on direct lending to Small and Medium sized Enterprises (SMEs) with a geographical focus in northern Europe including the UK.

The current investment opportunity is to invest in Beechbrook UK SME Credit III LP, which seeks to provide debt facilities to creditworthy UK based SME companies.

The firm has a proven track record in this sector with four European funds as well as two previous sterling denominated UK funds, and has accordingly demonstrated that it is capable of originating high quality transactions and achieving the targeted investment returns.

DIP previously committed £30m to Beechbrook's second fund (SME Credit Fund II) which has performed very strongly to date.

An investment of £40m by DIP in Beechbrook's Fund III is now proposed.

More information on the Manager is detailed in **Schedule 1.**

2.3 Investment Rationale

Fund III's strategy is a continuation of that of Fund II, i.e. to construct a diversified portfolio of loans to (and small upside equity investments in) a range of UK based SMEs with the aim of generating low volatility, attractive risk-adjusted returns and a strong running yield for investors.

The target market of Fund III is UK companies with sales typically in the range of £10m-£50m and EBITDA (i.e. operating profit) of £2m+ however the Manager may work outside these parameters from time to time. Based on

their experience and market feedback, Beechbrook believe that this area of the market is still experiencing a significant lack of external bank financing.

Beechbrook's expectation is that the Fund will be well diversified across 20+ investments, assuming a successful fundraise, and expect to make c.8 investments per annum, which would enable the fund to be fully invested within the three-year investment period.

Fund III had its first close in November 2021 and secured commitments of £95m (plus £25m in co-investment commitments) from British Business Investments as well as other LGPS investors.

2.4 Risks

The main risks of the proposed investment in Beechbrook's Fund III are considered to be as follows:-

- Default Risk
- Ability to source opportunities
- Economic recession

A summary of investment specific risks and key mitigants is contained in **Schedule 2**.

2.5 Projected Return

The fund's target investment return is a net IRR of 8%-9% which is considered achievable based on Beechbrook's track record to date, and appropriate given the intended structure and ranking of the debt in the companies which the fund is targeting.

The fund's objective is to generate low volatility, but attractive risk-adjusted returns, combined with an ongoing cash yield of 6%+ p.a.

2.6 Exit

The fund has an expected life of eight years, although this may be extended, subject to investors' agreement, by up to two additional years.

2.7 Fees

The Management Fee is modestly lower than DIP's experience of other debt funds during the Investment Period (IP) and at a similar level during the post-IP period. The fee will be calculated on total commitments during the IP and thereafter on the invested capital, which is in line with market practice.

Carried interest provisions also apply. These are structured such that Beechbrook Capital, as manager requires to perform strongly before it benefits under these provisions.

The fee structure for the Beechbrook UK SME Credit Fund III is in line with DIP's experience for a fund of this nature in the credit sector and is therefore considered acceptable.

2.8 ESG and Impact

DIP's credit investments make a positive impact in 3 broad areas:

- providing capital to SMEs, a sector of the market which has struggled to source funding since the retrenchment of the banks in the wake of the Global Financial Crisis;
- sustaining or creating employment - SMEs account for around 60% of UK private sector employment; and
- maintaining or improving Environmental, Social and Governance (ESG) standards in portfolio companies.

ESG factors cover a broad agenda, including issues relating to the workplace, community, marketplace, environment and governance. Beechbrook recognises that ESG factors can have a significant impact on their investments, creating sustainable value within companies.

More information on the investment manager's approach to ESG and Impact is included in **Schedule 3.**

2.9 Investment Size and Cash Requirements

SPF Fund value at 30th June 2022	£26,818m
DIP allocation (target 5% of main fund) NAV	£ 1,341m
Current DIP NAV	£ 1,219m
Headroom v NAV	**£ 122m**

2.10 Investment Strategy

The proposed investment falls within the Credit sector and therefore the Fund's short term enhanced yield allocation (STEY). Credit is a key area of investment focus for DIP.

Allocations following this investment, based on Fund values at 30th June 2022 and total DIP commitments to Credit, would be as follows:

Credit, £ in DIP	£ 237m
Credit, % in DIP	13%
Credit in DIP as % of Total Fund	0.88%
STEY, % Total Fund (target 20%)	18.2%

3 Policy and Resource Implications

Resource Implications:

Financial:	Investment of £40m to be drawn as required. Fee structure is in line with market.
Legal:	The investment will be subject to satisfactory completion of due diligence, including review and execution of appropriate legal documentation.

Personnel:	None.
Procurement:	None.
Council Strategic Plan:	Strathclyde Pension Fund aligns with the theme of a well governed city.
Equality and Socio-Economic Impacts:	
Does the proposal support the Council's Equality Outcomes 2021-25? Please specify.	Equalities issues are addressed in the Fund's responsible investment policy.
What are the potential equality impacts as a result of this report?	No specific impact from this proposal.
Please highlight if the policy/proposal will help address socio-economic disadvantage.	No specific impact from this proposal.
Climate Impacts:	
Does the proposal support any Climate Plan actions? Please specify:	Beechbrook has been a signatory to the PRI (UN-supported Principles for Responsible Investment) since 2019. This is consistent with Strathclyde Pension Fund's Climate Change strategy, which is being developed in line with Item 34 of the Council's Climate Action Plan.
What are the potential climate impacts as a result of this proposal?	No specific impact from this proposal.
Will the proposal contribute to Glasgow's net zero carbon target?	Potentially through the work of portfolio companies.
Privacy and Data Protection Impacts:	To be fully provided for in the legal documentation for the proposed investment.

4 Recommendations

The Committee is asked to **APPROVE** an investment of £40m in Beechbrook UK SME Credit Fund III by the Direct Impact Portfolio.

Schedule 1

Investment Manager: Beechbrook Capital

Beechbrook Capital is an independent private debt manager established in 2008 which is focused on direct lending to SMEs in Northern Europe including the UK.

Beechbrook Capital LLP is a limited liability partnership registered in England & Wales. It is a fund manager in the private credit market that focuses on lending to small to medium-sized companies in the UK and Europe. It began active investment in 2010 and currently manages funds with total original commitments of over £750m. It has made 79 investments to date.

Beechbrook operates from six offices across the UK and Europe. The business is headquartered in London, with five further offices in Manchester, Birmingham, Frankfurt, Cork and Dublin to support origination and portfolio management.

The Manager manages or advises funds that follow three distinct strategies:

Private Debt - Funds under this strategy provide senior and junior loans, and equity co-investments to private equity firms to support European buyouts, add-on acquisitions or refinancings. Beechbrook is currently raising its fourth fund under this strategy.

UK SME Credit - Funds under this strategy provide mainly senior secured loans alongside equity co-investments to UK businesses that are predominantly not private equity backed. Instead, they are owned by their founders, by families or other entrepreneurs and investors.

Beechbrook Ireland – Distinct strategy to support SMEs based in Ireland.

UK SME Credit I (“SME I”) held a first close in December 2015 and a final close at c. £152m in January 2017. It completed its investment programme in December 2018.

UK SME Credit II ("SME II") was launched in December 2018 and held a final close at £130m in March 2020. SME II has completed 13 investments to date and completed its investment programme in late 2021.

Their third UK fund (and the subject of this proposal) **UK SME Credit III** (“SME III”) has now held its first close and currently has 4 investments.

Schedule 2

Investment Specific Risks

Default Risk
The main risk of lending to smaller businesses is the risk of default of the underlying investee companies. Beechbrook mitigates this by detailed pre-investment appraisal and due diligence processes, which are designed to be "methodical, repeatable and consistent". Investments will only be made where the target company and the proposed terms are sufficiently attractive against pre-determined investment criteria.

A comprehensive due diligence process aims to evaluate the credit-worthiness of a borrower prior to making an investment and also to structure both debt and security so that they provide protection in the event of underperformance or credit deterioration. Beechbrook's internal procedures require them to fully consider all aspects of the proposed investment, including reviews of the applicable due diligence reports, visits to the company's sites, meetings with the management team, evaluation of the company's historical, current and projected financial performance and the negotiation of suitable legal documentation including financial covenants.

During the appraisal of potential transactions, the Beechbrook team maintains a regular dialogue with the fund's Investment Committee members on all aspects of the proposal. The successful track record of Beechbrook's prior UK SME funds to date provides comfort in respect of their debt assessment capabilities.

Ability to source opportunities
Beechbrook continues to experience strong demand for private debt funding given the large-scale withdrawal of retail banks providing debt to this segment of the market.

The lower mid-market segment of the UK market is populated by an estimated 27,000 businesses with a turnover between £10-£50m, which contrasts with c.7,000 businesses in the £50m+ turnover band, a smaller segment of the market which is targeted by more numerous and larger debt capital funds.

Beechbrook currently receives c. 200 good quality introductions per annum as a result of the success of Funds I & II, and the third fund seeks to continue the momentum developed as a result. Beechbrook remains confident in the strength of their pipeline and in their ability to invest the funds raised in Fund III.

Economic recession
Caused by a slowing business cycle, a global pandemic or other factors. This would lead to rising default rates in the market and possibly the fund.

Beechbrook has many years of credit experience and their investment professionals have worked through several credit cycles. Since Beechbrook was founded they have faced the Global Financial Crisis, Brexit and the Coronavirus pandemic.

Beechbrook are highly selective and disciplined in their investment process and have a highly experienced and independent Portfolio Management team that actively monitors investments, identifying potential problems early. The team also provides knowledge and resource to manage underperforming assets. Together, these help to protect the downside and to minimise potential loss given default.

Schedule 3

ESG and Impact

Beechbrook is a signatory to the UN-initiated Principles for Responsible Investment. These principles are incorporated in their investment analysis and investment decision-making process. Beechbrook also regularly report to PRI and investors on their ESG-related activities and portfolio company improvements. Beechbrook scored above peer average in their PRI Assessments in 2019 and 2020, receiving a rating of A+ and A both years.

Beechbrook is also a supporter of the Task Force on Climate-Related Financial Disclosures.

Beechbrook actively looks for investment opportunities in companies that promote best practice and lead their respective industry in ESG related matters.

Environmental
The issues in this field are diverse but the main areas are:

- Reduction of toxic emissions, fluids and other materials;
- Sustainability of resources;
- Efficient energy consumption;
- Permanent destruction of forests and other natural habitats;
- Responsible disposal of hazardous materials;
- The impact of climate change on businesses.

Social
During Beechbrook's due diligence process, their managers particularly look at the impact a company has on its staff, local communities and society as a whole.

The main areas of consideration are:

- Avoidance of any complicity in human rights abuses;
- Health and safety;
- Avoidance of child labour and related business practices;
- Inclusion, equality and diversity;
- Non-discriminatory practices;
- Avoidance of exploitative business practises.

Corporate Governance
Generally, corporate governance refers to the key rights and responsibilities of the management and the oversight of a company including values, structures, and accountability processes and procedures.

In the context of Beechbrook, this relates to the following areas:

- Management structures - checks and balances between members of the management team and the Board;
- Separation of duties;
- Incentive structures and executive remuneration;
- Stakeholder management;
- Corporate Codes of Conduct.