



Glasgow City Council

Strathclyde Pension Fund Committee

Report by Director of Strathclyde Pension Fund

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Item 4(c)

5th June 2019

**Direct Investment Portfolio (DIP)
Investment Proposal – Capital Dynamics Clean
Energy Infrastructure VIII**

Purpose of Report:

To set out a proposal for an investment of £40m within the Direct Investment Portfolio.

Recommendations:

The Committee is asked to **APPROVE** an investment of £40m in Capital Dynamics Clean Energy Infrastructure VIII Fund by the Direct Investment Portfolio.

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 was reviewed in 2012 and in 2015. It was re-branded as the Direct Investment Portfolio (DIP) in 2015. The most recent review of the DIP strategy and operating arrangements was concluded in December 2018.

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 2018 review is summarised below.

Direct Investment 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 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: £20m to £100m Minimum: £10m Maximum: greater of £200m 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

The following proposal has been assessed using this framework and is considered appropriate for recommendation to the Committee.

2 New Investment Proposal

2.1 Key Terms

Name	Capital Dynamics Clean Energy Infrastructure VIII
Investment vehicle	Luxembourg Special Limited Partnership
Manager	Capital Dynamics Limited
Sector	Renewable Energy
Investment objective	To acquire and construct a portfolio of clean energy projects mainly in the UK and also in certain mature markets in Europe
Term	12 years (plus up to 3x1 year extensions subject to Advisory Board approval)
Target size	£400m
Proposed DIP investment	£40m
Target return	Internal Rate of Return (IRR) of 12% to 15% (gross) / 10% to 12% (net)

2.2 Investment Summary

Capital Dynamics (CD) is a global private asset investor with over \$15bn Assets Under Management (AUM). Founded in 1999, the Firm has 160+ professionals in 11 offices located in major financial cities worldwide.

The Clean Energy Infrastructure (CEI) platform was established in 2010 to allow direct investment in real assets within the renewable energy sector. To date the platform has \$5.9bn AUM invested in 4.6GW of power generation assets across 100+ sites.

The focus of CD's CEI platform and its 7 previous funds has been on investment in the renewable energy sector. As well as the development of traditional renewable energy assets, Fund VIII also intends to explore opportunities beyond this to include other types of infrastructure e.g. electric vehicle infrastructure and grid support.

An investment of £40m by DIP in Capital Dynamics Clean Energy Infrastructure VIII is proposed.

More information on the investment manager is included in **Schedule 1**.

2.3 Investment Rationale

Both UK and Scottish Governments have long term commitments to the increased use of renewable energy. This is driven partly by commitments given to the EU to generate 15% of all power from renewable energy by 2020 and also by the need for energy security. A potential shortage in energy supply anticipated over the next decade also necessitates an increase in renewable energy investment.

CD's CEI Fund VIII is targeting significant exposure to the Scottish renewable energy market. They view Scotland as one of Europe's most exciting renewable energy markets with up to 17GW of new renewable energy infrastructure capacity required by 2030 to meet its de-carbonisation targets.

CD has a 213MW cornerstone portfolio of pre-construction onshore wind projects located mainly in Scotland under exclusivity for investment by the Fund. The portfolio will benefit from 100% fixed revenues for 15+ years on completion under corporate Power Purchase Agreement (PPAs) with global investment grade counterparties. The assets however will not benefit from the government's renewable energy subsidy regime which has now ended.

2.4 CD CEI VIII Fund Description

Capital Dynamics Clean Energy Infrastructure VIII will be deployed in investment opportunities in operational, construction-ready and late stage development assets, as well as operational assets with perceived growth potential. The expectation is that the fund will invest in c.10-15 assets with an average investment size of £30m - £50m.

CD are highly experienced in constructing windfarms and other renewable assets and are comfortable managing construction risk.

Funds are typically raised only when a firm pipeline of assets has been identified and under exclusivity, to avoid the risk of delays in deployment.

It is intended that the fund will be invested in the UK (75%+) and continental Europe (maximum 25%), in both greenfield and brownfield investments in onshore wind, solar PV, hydro, electric storage and with clean energy infrastructure associated technologies.

Fund VIII held its first close in April 2019 with investor commitments of £114m from 8 LGPS investors and CD anticipate raising a further £128m at the next close in Q3 2019.

2.5 Investment Specific Risks

The main risks of the proposed investment in the fund are considered to be as follows:-

- Ability to Source Opportunities
- Operational Risk
- Sector Specific Risk
- Regulatory or Legislative Risk

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

2.6 Projected Return

The targeted return is an IRR of 10% - 12% (net), based on a value-add strategy of the origination of smaller assets, economies of scale through aggregation, the management of the construction phase, and addition of leverage to optimise the financial structure.

2.7 Exit

Assets will provide a high single-digit cash yield once operational. Technically and commercially de-risked, post-construction assets have many natural buyers including generalist long-term infrastructure funds and non-traditional buyers. This may present opportunities for early exit or assets may be held and realised towards the end of the Fund's term.

2.8 Fees

Fees are competitive with DIP's current experience in the renewable energy market and include a step down at the end of the investment period.

SPF will benefit from a modest LGPS discount.

2.9 Environmental Social and Governance Issues

Renewable energy is at the forefront of efforts to de-carbonise the global economy. An Environmental, Social & Governance (ESG) investment policy is integrated into Capital Dynamics' investment analysis, investment decisions and post investment processes. Capital Dynamics was an early signatory of the Principles for Responsible Investment in 2008.

The Fund's targeted wind projects will directly contribute over £12m in local community funding over their useful life of 25 years. The projects will additionally create significant levels of new employment in Scotland and the rest of the UK during their construction and operating phases, which will be added to their existing diverse Scottish onshore wind portfolio, which comprise 5 operating projects with 55MW of generation capacity.

2.10 Investment Size and Cash Requirements

SPF Fund value at 31 st March 2019	£21.9bn
DIP allocation (target 5% of main fund) NAV	£1,095m
Current DIP NAV	£724m
Headroom v NAV	£371m

2.11 Investment Strategy

The proposed investment falls within the Infrastructure/Renewable Energy sector and therefore the Fund's long term enhanced yield allocation. Infrastructure (renewable energy infrastructure in particular) is a key area of investment focus for DIP.

Allocations following this investment, based on Fund values at 31st March 2019 and total DIP commitments to infrastructure / renewable energy, would be as follows:

Infrastructure/Renewable Energy, £ in DIP	£730m
Infrastructure/Renewable Energy, % in DIP	64%
Infrastructure/Renewable Energy, % Total Fund	3.3%
LTEY, % Total Fund (target 20%)	16%
Limited partnership, % Total Fund (maximum 30%)	12.4%

3 Policy and Resource Implications

Financial: Investment of £40m to be drawn as required. Overall the fees are 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: Not applicable.

Equality and Socio-Economic Impacts:

Does the proposal support the Council's Equality Outcomes 2017-22 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.

**Sustainability
Impacts:**

<i>Environmental:</i>	See section 2.9
<i>Social, including Article 19 opportunities:</i>	See section 2.9
<i>Economic:</i>	See section 2.9

**Privacy and Data
Protection impacts:** To be fully provided for in the legal documentation for the proposed investment.

4 Recommendation

The Committee is asked to **APPROVE** an investment of £40m in Capital Dynamics Limited by the Direct Investment Portfolio.

Investment Manager: Capital Dynamics Limited

Capital Dynamics is an independent global asset management firm focusing on private assets including private equity, private credit, clean energy infrastructure and clean energy infrastructure credit.

The Firm currently has 11 offices located in major financial centres worldwide and has over 160 employees. Its wealth of international experience is an important resource in assessing investment opportunities, evaluating managers and funds as well as servicing its clients worldwide.

The **Clean Energy Infrastructure Team** comprises 15 professionals who are based in the Firm's New York and London offices with a combined total of 160 years of investing in CEI assets. Established in 2010 the team has successfully raised, and invested 9 funds with AUM of over \$5.9bn (£4.6bn).

CD has invested extensively in CEI assets across the globe with what they believe are strong results. As of July 2018, Capital Dynamics has invested in projects with 4.6GW of generation capacity. Globally, the CEI Team manages more than 100 project sites in its current portfolio.

Fund VIII will primarily focus on making investments, including follow-on investments, in clean, low-carbon and renewable energy businesses and projects, primarily in the core UK market and also in certain mature markets in Europe on a limited basis.

The Fund Manager, Capital Dynamics Limited, is authorised and regulated by the UK Financial Control Authority (FCA).

Investment Specific Risks**Ability to Source Opportunities**

The Fund intends to focus on acquiring CEI assets in the UK and to a lesser extent also in certain mature European markets. The risk of failing to secure suitable investment opportunities is mitigated by CD's high profile and extremely strong track record in the renewable energy marketplace, such that there are few opportunities that the CD team are not aware of. They also raise funds from potential investors only after securing exclusivity on opportunities and have a robust pipeline, so the risk of CD failing to source suitable opportunities is considered low.

Operational Risk

There is always a risk that assets will not perform as forecast due to technical issues caused by weather or other factors. To mitigate this risk CD aim to construct a portfolio which is diversified by both geography and technology and directly employ sector specialists to remotely monitor the performance of the assets. The ongoing repair and maintenance obligations on the portfolio are undertaken by external contractors, speed of response and rectification is critical in minimising operational downtime and therefore revenues. Wind turbines incorporate manufacturers' warranties covering minimum availability performance levels and also typically incorporate insurance policies for underperformance.

Sector Specific Risk

Clean energy projects are long-term assets with economic lives often exceeding 20 years. The performance of each asset will be dependent upon wind, solar and/or rainfall conditions at each site, which by their nature are unpredictable from year to year and can potentially affect electricity generation levels and ultimately revenues. Over the long term however weather conditions and therefore asset revenues will tend towards long term averages. An important part of CD's due diligence process is to carefully consider the long term energy generation expectations of each asset.

Regulatory or Legislative

Renewable energy proposals previously considered by DIP have had the benefit of being underpinned by the government's renewable energy subsidy regime, which has now come to an end. The current proposal from CD therefore comprises the first proposal for the development of renewable energy assets without subsidy support.

There is therefore greater reliance on the strength of the PPA counterparties to reduce the market risk of fluctuating energy prices. In the event of adverse events affecting the counterparties then CD will require to secure alternative arrangements (or PPA counterparties) to hedge the risk of energy price volatility.