Item 7(a)

26th June 2024

Glasgow City Council

Strathclyde Pension Fund Committee

Report by Richard McIndoe, Director of Strathclyde Pension Fund

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Direct Impact Portfolio (DIP)
Investment Proposal – Palatine Private Equity Fund V

Purpose of Report:

To set out a proposal for an investment of £30m within DIP.

Recommendations:

The Committee is asked to **APPROVE** an investment of £30m in Palatine Private Equity Fund V by DIP.

Ward No(s): Citywide: ✓

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

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	**Palatine Private Equity Fund V**
Investment vehicle	English Limited Partnership
Manager	Palatine Private Equity LLP
Sector	Growth Capital
Investment objective	To invest private equity into growth-orientated companies in the UK lower mid-market with a regional focus outside London.
Term	10 years (subject to extensions)
Target size	£250m (Hard Cap £300m)
Proposed DIP investment	£30m
Target return	Internal Rate of Return (IRR) of 20% (Net) / MOIC 2.0x

2.2 Investment Summary

Palatine Private Equity LLP ("Palatine") is a Manchester-based, regionally focused, UK lower mid-market ("LMM") private equity ("PE") investor, controlled and owned by its Managing Partners, who together have over 96 years' experience of sourcing, executing and managing PE supported businesses in the UK.

Palatine Private Equity V ("Fund V" or "the fund"), an English limited partnership with a target size of £250m, intends to continue Palatine's proven strategy of focusing primarily on Growth Capital ("GC") investments of between £10m and £30m in businesses based in the regions of the UK with an enterprise value of up to £100m.

Fund V will mark a continuation of Palatine's strategy in predecessor funds of partnering with regional UK LMM companies to help accelerate growth, build value, and achieve strong results for its limited partners.

DIP has previously invested £25m in both Palatine Private Equity Fund IV and Palatine Impact Fund II. Fund IV has performed very strongly and whilst it is early in the life of the Impact Fund, the indications to date suggest a strong performance will be achieved.

An investment of £30m by DIP in Palatine Private Equity Fund V is proposed.

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

2.3 Investment Rationale

Palatine is raising Fund V to continue the Firm's proven strategy of making predominantly majority-owned or control-orientated investments in LMM companies operating in the regions of the UK.

Fund V will seek to invest in transactions that will normally be the result of shareholder reorganisations, with the majority of deals expected to be buyouts and/or buy-and-build opportunities, the latter being where the portfolio company has an established platform on which to acquire, integrate and grow smaller businesses in the same market.

The fund will primarily focus on profitable, cash-generative companies using the experience and expertise Palatine has developed in the technology; financial; healthcare; and business service sectors to identify potential business opportunities.

Whilst each individual transaction will have different characteristics there are several features that the fund will look to achieve. These include:

- A management team with a proven track record;
- An attractive entry price;
- Controlling shareholdings in most transactions; and
- A clear and defined exit strategy.

The fund will continue Palatine's historical focus on scalable business models, seeking to generate PE returns by supporting and implementing operational changes and initiatives that the companies themselves have been unable to identify or execute.

Palatine has demonstrated the ability to identify and complete these types of transactions in its prior funds, which in many cases have been sourced as a result of the team's local base, networks and knowledge. Circa 80% of platform investments have completed at least one acquisition and Palatine's portfolio companies have made a total of over 200 acquisitions since 2007.

The first close for Fund V took place on 19th April 2024 with c. £100m of commitments. Palatine currently anticipates a further £150m+ of commitments from a variety of pension funds, and other institutional investors. Palatine itself will invest £5m in the fund.

Palatine is currently investing its fourth fund (Fund IV), a £200m pooled investment vehicle. As of March 2024, this fund has made eight investments and is 75% committed including reserves.

2.4 Risks

The main risks of the proposed investment are as follows:

- Sourcing Opportunities
- Private Equity Risk
- Key Personnel

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

2.5 Projected Return

The fund is targeting an investment return of 20% IRR (Net) and a Multiple of Invested Capital (“MOIC”) of 2.0x. This is considered appropriate for a GC fund investing in this segment of the market.

2.6 Exit

The fund will have a basic term of 10 years comprising a 5-year Investment Period (IP), followed by a holding period of 5 years with up to 2x1 year extensions. Repayment of capital and investment returns are expected to come from asset realisations.

2.7 Fees

The management fee is typical of the managers in DIP’s equity/GC portfolio. The fee will be calculated on investor commitments during the IP and thereafter on the invested capital, which is in line with market practice.

Carried interest (or performance related) provisions also apply to the fund. These will be structured such that Palatine, as manager will require to perform strongly before it benefits under these provisions.

The Management Fee is in line with DIP’s typical experience in the GC market, while the Carried Interest structure/rates are relatively typical. Overall, the fee levels are considered acceptable.

2.8 Impact and ESG

Palatine has embedded ESG into all aspects of its business and has recently also achieved B Corp status, an external, independently verified accreditation demonstrating high standards of social and environmental performance, transparency, and accountability. Palatine scored 111.3 out of 200 in the B Impact Assessment, making it Europe’s fourth highest-scoring PE firm achieving B Corp status.

A summary of the ESG and Impact factors of the fund are contained in **Schedule 3**.

2.9 Investment Size and Cash Requirements

SPF Fund value at 31st March 2024	£30,245m
DIP allocation (target 5% of main fund) NAV	£ 1,512m
Current DIP NAV	£ 1,490m
NAV Range (Lower) 2.5%	£ 756m
NAV Range (Upper) 7.5%	£ 2,268m

2.10 Investment Strategy

The proposed investment falls within the Growth Capital sector and therefore the Fund's Equity allocation. Equity is a key area of investment focus for DIP.

Allocations following this investment, based on Fund values at 31st March 2024 and total DIP commitments to Equity, would be as follows:

Equity, £ in DIP	£331m
Equity, % in DIP	15%
DIP Equity, % of Total Fund	1%

3 Policy and Resource Implications

Resource Implications:

Financial: Investment of £30m to be drawn as required. Fee structure is considered to be in line with the 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: SPF supports the mission: ***to enable staff to deliver essential services in a sustainable, innovative and efficient way for our communities***. The LGPS is one of the key benefits which enables the Council to recruit and retain staff.

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? None

Please highlight if the policy/proposal will help address socio-economic disadvantage.	None

Climate Impacts:

Does the proposal support any Climate Plan actions? Please specify:	Yes – Palatine has been a signatory to the PRI (UN supported Principles for Responsible Investment) since 2010 and is a certified carbon neutral organisation which has recently become accredited as a B Corp Certified organisation. After years of leadership in the private equity sector, Palatine gained external verification and scored in the top four PE houses in Europe. 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. Palatine are also active supporters or signatories of various initiatives which seek to promote Climate Plan credentials of both the GC industry and the companies in which it invests.
What are the potential climate impacts as a result of this proposal?	No specific contribution from this proposal, although there are anticipated to be a number of investments in the sustainability space and which will result in the reduction or displacement of carbon emissions.
Will the proposal contribute to Glasgow's net zero carbon target?	No specific contribution from this proposal.

Privacy and Data Protection Impacts:	To be fully provided for in the legal documentation for the proposed investment.
Are there any potential data protection impacts as a result of this report Y/N	N

If Yes, please confirm that a Data Protection Impact Assessment (DPIA) has been carried out

4 Recommendations

The Committee is asked to **APPROVE** an investment of £30m in Palatine Private Equity Fund V by DIP.

Schedule 1 **Investment Manager: Palatine Private Equity Fund V**
Schedule 2 **Investment Specific Risks**
Schedule 3 **Impact and ESG**

Investment Manager: Palatine Private Equity Fund

Palatine is a regional, independent private equity ("PE") firm founded in 2005 and managed by its Partners, who are the decision-makers within the firm based in the target regions in their offices in Manchester, Birmingham and London. It is an established firm operating in the UK lower mid-market ("LMM") part of the PE investment market with a regional focus and a head office outside London, as opposed to a having a London head office and regional network. Palatine is headquartered in Manchester and its satellite offices in London & Birmingham are focused on executing opportunities in the Southern and Midlands regions of England respectively.

Palatine believes that its regional presence, combined with the seniority and track record of the Partners, has been important in originating high quality transactions. It expects that this will continue for Fund V.

Consistent with the strategy successfully adopted in the Prior Funds, Fund V investments are expected to primarily be made in the regional centres of the UK outside of London with a particular emphasis being placed on the North-West, North-East and Yorkshire regions of England through Palatine's Manchester office. Investments made in the South of England will be focused in the South-East and South-West of England. Investments will also be made in the Midlands through Palatine's Birmingham office which was opened in 2016.

The investment of Fund V will be led by Gary Tipper, Tony Dickin, Ed Fazakerley, Andy Lees (Managing Partners, with a combined 96 years' experience in the PE sector) and Richard Thomas and Andy Strickland (collectively the "Partners"), who have worked together at Palatine for an average of 14 years. They are supported by a cross functional team of 23 professionals.

The Partners have gained extensive commercial experience through their involvement in PE investments. This includes experience of negotiating, structuring, and undertaking due diligence on transactions, as well as experience gained post investment through active participation on the boards of portfolio companies. The Partners have a demonstrable record of value creation over a sustained period.

The senior investment team is further supported by a group of junior investment professionals comprised of complementary skill sets and functional experience including backgrounds in private equity, investment banking, consulting, and corporate finance. These backgrounds provide additional depth in identifying, executing, and growing investments.

Palatine is authorised and regulated by the Financial Conduct Authority.

Investment Specific Risks

Sourcing Opportunities
The ability to originate a pipeline of attractive opportunities in the lower mid-market segment of the UK market is a key factor in the potential success of the fund. Having been established for 19 years with four prior funds, total commitments of £650m+ and 38 investments, Palatine has a relatively high profile in the regional markets and consequently benefits from a steady flow of referrals from its network of contacts and traditional introducers. There is no reason to believe this will not continue

Private Equity Risk
The proposed investment is to a PE fund, which operates in a relatively risky segment of the financial market with no guarantee of success. A PE fund would traditionally anticipate a number of investment losses, a larger number of moderately successful investments and hopefully one or two "stellar" investments, which combine to generate the blended / relatively high targeted return. The principal comfort in this regard is Palatine's track record in its four previous funds which have generated returns to date of 24%, 10%, 30% and 43% respectively, with 21 asset exits to date out of a total of 38 investments.

Key Personnel Risk
The risk of over-reliance on key personnel is pertinent to any manager and indeed Palatine consider that they were relatively under-resourced during a growth phase coinciding with their second fund, and which partially contributed to the lower return for this fund. This was remedied well in advance of Fund III and indeed further recruitment has continued in line with demand.

The success of Palatine has been built on a strong team comprising 6 partners (with well over 100 years combined PE experience), 23 other investment professionals, plus further support functions. It is considered that there is sufficient strength and experience in the team to deliver the proposed strategy for Fund V.

Schedule 3

Impact and ESG

Palatine has a dedicated Sustainability Team led by Stephanie Wall (Senior Sustainability Director) and is a fully participating signatory to the UN Principles for Responsible Investment. Since 2010, Palatine has developed a proprietary Sustainable Investment Policy of ESG (environmental, social and governance) evaluation, engagement and management throughout the investment lifecycle, from the outset of considering an opportunity through to exit.

Stephanie joined Palatine in 2018 from an environmental consultancy; she has over eight years' experience in the Responsible Investment ("RI") sector advising on ESG risks and opportunities. The team at Palatine recognise that ESG factors play a material role in determining the risk and return in investments. Stephanie delivers advice in this respect throughout the investment lifecycle, which is crucial in the delivery of Palatine's ESG Working Principles. Post-investment she works with management teams to realise the importance and value in good ESG performance, engaging with management to assess and manage applicable risks and impacts and to identify and capitalise on opportunities.

Additionally, Palatine's two-person Sustainability Team are dedicated to advising and implementing material ESG policies within Palatine's portfolio companies. This bespoke resource not only guides companies to follow Palatine's Working Principles but also manages ESG risks, capitalises on new initiatives and shares best practice between portfolio companies.

Fund V is an Article 8 fund under the EU Sustainable Finance Disclosure Regulations (SFDR). This means that the fund will promote environmental or social characteristics alongside financial objectives, and which will integrate sustainability into the investment process in a binding manner.

Palatine is considered a market leader in demonstrating ESG and RI and has won a number of awards as well as engaging in a significant number of industry leading initiatives which include:

- BVCA (British Private Equity & Venture Capital Association) Excellence in ESG Award: General Partner, AUM less than $1bn in 2021 and 2023;
- British Private Equity Awards; Responsible Investor of the year in 2017, 2019 and 2020;
- Signatory to the Investing in Women Code, as signed in 2023;
- Set a science-aligned carbon reduction target, that has been verified by the Science Based Targets initiative (SBTi) ;
- Silver level carbon literate organisation and a commitment to maintaining a carbon literate organisation;

Schedule 3

Impact and ESG

- Early joiners of the initiative Climate International (Ici) committing to actively engage with the industry and portfolio companies to reduce carbon emissions; and
- Joined the ESG Data Convergence Initiative (EDCI) supporting the aim to create greater transparency and convergence on ESG reporting.