



Glasgow City Council

Strathclyde Pension Fund Committee

Report by Richard McIndoe, Director of Strathclyde Pension Fund

Item 6(c)

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**Direct Investment Portfolio (DIP)
Investment Proposal - Dalmore Capital Fund 4**

Purpose of Report:

To set out a proposal for an investment of £50m within the Direct Investment Portfolio.

Recommendations:

The Committee is asked to **APPROVE** an investment of £50m in Dalmore Capital Fund 4 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 the UK and 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 review by the Sounding Board with a view to a recommendation being made to the Committee.

2 New Investment Proposal

2.1 Key Terms

Name	Dalmore Capital Fund 4 LP
Investment vehicle	English Limited Partnership
Manager	Dalmore Capital Limited
Sector	Infrastructure
Investment objective	To build a portfolio of low volatility, defensive infrastructure assets mainly in the UK, with the aim of delivering stable, inflation-linked cashflows to investors
Term	15 years (plus up to 2 years' extension)
Target size	£1bn
Proposed DIP investment	£50m
Target return	8%-10% IRR (Net)

2.2 Investment Summary

Dalmore Capital (Dalmore) was established as an independent fund manager in 2009 to invest in long term, low volatility, UK infrastructure assets.

Its investment strategy is designed to deliver diversified portfolios of high quality, defensive infrastructure assets which provide its institutional investors with attractive, long term yield and inflation-linked returns which are resilient under a range of economic and market conditions. These assets typically do not have significant exposure to the prevailing state of the economy, demand based revenue streams, or market risks.

An investment of £50m by DIP in Dalmore Capital Fund 4 (DCF4) is proposed.

DIP has previously invested £50m in the Dalmore PPP Equity PIP Fund, and an additional £50m in DCF4's predecessor fund (DCF3). The performance of both funds is progressing very well.

Note that an additional investment of £50m in Dalmore SPF Co-investment Fund is also proposed which is the subject of a separate paper.

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

2.3 Investment Rationale

Dalmore focuses on acquiring long term, core infrastructure assets which exhibit the following characteristics:-

- assets which provide essential services to the population;

- are fundamental to a country's long-term economic growth;
- have a stable legal and regulatory environment;
- have significant barriers to entry;
- have revenues which are contracted, inflation-linked and availability based (i.e. not reliant on the level of usage of the asset); and
- which are anticipated to demonstrate a relatively high degree of revenue stability, low volatility of returns and regular/predictable yield.

The investment strategy for DCF4 is based on the potential to secure additional stakes in several identified, follow-on and/or linked investment opportunities in respect of assets already part-owned by existing Dalmore funds. It is anticipated that opportunities to acquire additional stakes will arise in the energy from waste, rolling stock and regulated sectors and will be supplemented by other opportunities in the wider infrastructure market. Overall, Dalmore anticipates that DCF4 will be deployed in the Waste (20-30%), Digital (20-30%), Transport (20-30%), Water (10-20%), Energy (10-20%) and/or Electricity Transmission (10-20%) sub-sectors.

Over the past decade, Dalmore has constructed a portfolio of stakes in over 120 infrastructure projects. This has resulted in the team establishing strong relationships with potential sellers (or introducers) of such assets, such as the government, asset developers, financial/commercial investors and advisors. Where possible they will seek to acquire assets outwith auction processes or where they perceive competition to be limited.

Dalmore's co-investors in a given asset are often attracted to sell their stakes to Dalmore in the knowledge that as an existing investor, often with contractual pre-emption rights, the firm is well positioned to acquire additional stakes quickly without the need for significant additional due diligence (DD). This can inhibit potential third party bidders from incurring significant DD costs of their own and potentially leads to enhanced returns for Dalmore. The existing portfolio of asset stakes therefore provides opportunities to increase/consolidate holdings.

Dalmore has a long and successful track record of successfully sourcing attractive opportunities and deploying funds relatively quickly.

Sub-sectors of the infrastructure market which were targeted by previous Dalmore funds, but which are now less likely to be acquired because of increasing prices and diminishing potential returns, include operational PPP and/or renewable energy assets and OFTOs (offshore wind grid infrastructure).

DCF4 will focus on UK opportunities, but may also invest up to a maximum of 20% of the fund in other EEA countries, the US, Canada

and/or Australia, although in practice it is not expected to invest outwith the UK to this extent.

2.4 Risks

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

- Origination Risk;
- Construction/Operational Risk;
- Lifecycle Costs;
- Risk of Termination of Project Agreements; and
- Brexit.

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

2.5 Projected Return

The fund's targeted return is an Internal Rate of Return (IRR) of 8%-10% (Net) which is considered to be an acceptable return for a portfolio of mainly operational and lower risk UK infrastructure assets. The potential volatility from this target return is expected to be modest.

2.6 Exit

DCF4 has a term of 15 years although this may be extended by up to 2 years by the Manager. The fund has a 5 year investment period although it is expected that the funds will be deployed well within this time.

2.7 Fees

The management fee is weighted towards the invested capital rather than the committed capital during the investment period and is in line with DIP's current experience in the infrastructure market.

SPF will benefit from both "First Close" and "LGPS" discounts, with the commitments of all LGPS investors being aggregated by Dalmore for the purposes of the latter discount. Carried interest provisions also apply to DCF4, and are in line with the equivalent structure applying under DCF3.

Overall the fee structure is considered satisfactory.

Given the performance of their previous funds, it is not anticipated that Dalmore will have any significant difficulty in raising the full targeted fund size of £1bn.

2.8 Environmental Social and Governance Issues

Dalmore seeks to invest in projects that bring positive social impacts, through the provision of new and/or refurbished infrastructure assets which support the delivery of essential public services, including schools, hospitals and housing.

It avoids investing in assets that could be detrimental to the environment or that involve reputational risk and has established rigorous investment processes to identify key risks under internal as well as third party, legal,

commercial and technical due diligence processes prior to acquiring any asset.

Dalmore has been a signatory to the PRI (UN Principles for Responsible Investment) since 2013.

2.9 Investment Size and Cash Requirements

SPF Fund value at 30 th September 2020	£23.701bn
DIP allocation (target 5% of main fund) NAV	£1,185m
Current DIP NAV	£866m
Headroom v NAV	£319m

2.10 Investment Strategy

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

Allocations following this investment (and a £50m investment in Dalmore SPF Co-investment Fund), based on Fund values at 30th September 2020 and total DIP commitments to infrastructure/renewable energy, would be as follows:

Infrastructure/Renewable Energy, £ in DIP	£813m
Infrastructure/Renewable Energy, % in DIP	62.2%
Infrastructure/Renewable Energy, % Total Fund	3.4%
LTEY, % Total Fund (target 20%)	15.9%

3 Policy and Resource Implications

Financial: Investment of £50m to be drawn as required. Fee structure 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 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.

An element of the fund could potentially be invested in healthcare, education and/or social housing assets.

Sustainability Impacts:

*Environmental:
Social, including opportunities under Article 20 of the European Public Procurement Directive:
Economic:*

See section 2.8
See section 2.8

See section 2.8

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 £50m in Dalmore Capital Fund 4 by the Direct Investment Portfolio.

Investment Manager: Dalmore Capital

Dalmore Capital (Dalmore) is a prominent investor in the UK infrastructure sector, having assets under management (AUM) of over £5.2bn invested on behalf of institutional investors including many of the UK's largest pension funds and a number of large overseas investors. Dalmore has become a key conduit through which pension funds and other long term investors have been able to invest in significant infrastructure assets, having constructed a portfolio of over 120 infrastructure assets since its formation in 2009.

Dalmore's 3 founder partners, Michael Ryan (CEO), John McDonagh (COO) and Alistair Ray (CIO) have worked together for almost 20 years in a variety of companies and capacities including as developers, equity sponsors and investors. They have managed various infrastructure funds, led investment teams on large and complex transactions as well as being involved in asset management roles.

The founder partners are supported by John Murphy (CFO) and a team of highly experienced infrastructure directors with a combined experience of over 500 years in asset acquisition, management & specialist functions. This investment experience extends to social and regulated infrastructure, student accommodation, renewable energy, conventional power generation/transmission and transportation assets.

Investment Specific Risks

Origination Risk

The Dalmore investment team are extremely well established in the infrastructure marketplace and benefit from seeing a steady pipeline of opportunities. Their track record over several previous funds suggests that the origination risk is low.

Construction / Operational Risk

With all infrastructure projects/assets, there is a risk that the contractual &/or warranty arrangements with the design and construction subcontractors may not be as effective as intended. Recourse may also be subject to liability restrictions or the insolvency of a main construction (or facilities management) contractor, as seen in recent times with both Carillion & Interserve. Measures such as performance bonds, contract retentions and latent defects provisions are always incorporated into the legal documentation, however the failure of these two companies serves to highlight the real risks in this respect as well as the level of contingency planning required to be undertaken by fund managers operating in the sector.

Lifecycle Costs

During the lifetime of each asset or concession, certain components of the facility will require replacement or refurbishment, the timing of which is based on forecasts. Shorter than anticipated lifespans or higher than anticipated costs, if not recoverable from the subcontractor concerned, may result in higher lifecycle costs for the asset holding entity. A full technical review of the lifecycle cost provisions for each asset is undertaken pre-acquisition.

Risk of Termination of Project Agreements

Under PPP projects, the employer and the project entity typically have the right to terminate a project agreement under certain circumstances and the compensation payable (if any) depends on the reason. A full review of the termination provisions of each asset is undertaken as part of the due diligence ("DD") process.

Brexit

Core infrastructure investments are defensive in nature in times of political and economic uncertainty and offer investors predictable, long term, inflation-linked contracted cashflows. There is a fundamental requirement for high ongoing levels of infrastructure expenditure in the UK, which will not change under any of the potential Brexit outcomes. Clearly, however, neither the current uncertainty, nor the likelihood of disruption post-Brexit, in whatever form it takes, is helpful to the sector.