

**Item 6(d)**

**25<sup>th</sup> November 2020**



**Glasgow City Council**

**Strathclyde Pension Fund Committee**

**Report by Richard McIndoe, Director of Strathclyde Pension Fund**

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**Direct Investment Portfolio (DIP)  
Investment Proposal - Dalmore SPF Co-investment Fund**

**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 SPF Co-investment 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.

<b>Direct Investment Portfolio</b>	
<b>Objectives</b>	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.
<b>Strategy &amp; Structure</b>	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.
<b>Risk and Return</b>	Portfolio benchmark return of <b>CPI +3% p.a.</b> Individual risk and return objectives for each investment.
<b>Capacity</b>	Target allocation of <b>5%</b> of total Fund (based on Net Asset Values). Range of <b>2.5%</b> to <b>7.5%</b> of total Fund.
<b>Investment Size</b>	Target: <b>£20m to £100m</b> Minimum: <b>£10m</b> Maximum: greater of <b>£200m</b> or <b>1%</b> of Total Fund Value
<b>Decision Making</b>	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.
<b>Monitoring</b>	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

<b>Name</b>	<b>Dalmore SPF Co-investment Fund</b>
<b>Investment vehicle</b>	English Limited Partnership
<b>Manager</b>	Dalmore Capital Limited
<b>Sector</b>	Infrastructure
<b>Investment objective</b>	To facilitate the acquisition of additional co-investment stakes in larger, low volatility, UK infrastructure assets, with the aim of delivering stable, inflation-linked cashflows to SPF
<b>Term</b>	15 years (plus up to 2 years' extension)
<b>Target size</b>	£50m
<b>Proposed DIP investment</b>	£50m
<b>Target return</b>	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.

The firm is periodically also presented with other attractive opportunities which are too large for the main fund concerned due to concentration restrictions. In these situations, Dalmore offers the balance of such stakes to co-investors, who actively want to have increased exposure to such assets.

An investment of £50m by DIP in Dalmore SPF Co-investment Fund (CIF) is proposed. This is additional to a proposed investment of £50m by DIP in Dalmore Capital Fund 4 (DCF4) which is the subject of a separate paper.

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.

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).

## **2.4 Co-investment**

Co-investment is an additional investment in an individual asset made by a portfolio investor alongside a fund investment in that asset. SPF has extensive, successful co-investment programmes within its private equity portfolios. In December 2018, the Committee agreed that DIP should investigate co-investment opportunities in infrastructure.

## **2.5 Dalmore and Co-investment**

In general, Dalmore acquires stakes in medium sized assets which are too small for global infrastructure funds.

The Manager is, however, regularly presented with attractive opportunities which are too large for their main funds to acquire in their entirety. This may be due either to pre-determined fund concentration limits which are set to ensure that the main funds are sufficiently diversified, or simply that a smaller stake would be more appropriate for the fund concerned.

In these cases, Dalmore will offer the balance of that particular asset to one, or more usually a number, of co-investors. These are investors who wish to deploy additional sums into either larger assets or particular sub-sectors of the infrastructure market. Dalmore anticipates such opportunities continuing to arise in the future.

Individual opportunities often arise at relatively short notice and require a rapid response by potential co-investors. To manage this, it is proposed that SPF should take a portfolio approach. This is consistent with DIP's structure and processes.

## **2.6 Dalmore SPF Co-investment Fund**

The proposal is to create a Co-investment Fund (CIF) solely for SPF. Dalmore will have discretion to manage the CIF subject to a number of parameters/restrictions as follows:

- co-investments to be made only in UK assets;
- co-investments to be in assets in which DCF3 or DCF4 are also acquiring a stake;
- co-investments to be a maximum of £15m in any single asset;
- a summary report of the proposed co-investment transaction to be provided to SPF prior to acquisition;
- SPF to have a right of veto of the proposed transaction;
- SPF to have the right to consider "topping up" the CIF in the future (subject to separate Committee approval at the applicable time);
- potential, with SPF consent, for the CIF to invest alongside any successor Dalmore main fund (e.g. DCF5) in the future.

It is felt unlikely that the transaction veto would be utilised, as only assets which satisfy the investment criteria of DCF3/4 could be considered for co-investment. One exception however, could be cases of potential over-concentration in a particular asset, where another infrastructure fund (or equivalent co-investment vehicle) in which SPF was also

invested, also had a significant exposure in the same asset. The right of veto however, which will be exercised by SPF officers, provides an additional measure of control.

The CIF has been designed to assist SPF to:

- deploy incrementally more funds into infrastructure;
- manage portfolio diversification; and
- take advantage of lower fee structures on co-investments (see below) which will reduce the overall blended cost of the main fund and CIF investment strategies.

## **2.7 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**.

The proposed investment in the CIF concentrates these risks – i.e. the Fund will have larger stakes in fewer assets in comparison to the DCF4 investment. The mitigants are the same. The Manager has experience of running co-investment programmes, and there will still be sufficient diversification within the more concentrated CIF portfolio. Co-investment will also help DIP manage the risk of over diversification.

## **2.8 Projected Return**

The targeted return for the CIF is the same as for DCF4, i.e. an Internal Rate of Return (IRR) of 8%-10% (Net).

While the targeted return is the same, the actual return (while expected to be similar) will not exactly match that of DCF4. This is a result of the ability to invest in DCF3/DCF4 assets, the greater concentration of CIF assets, and the lower fee which should improve the CIF's net return.

The targeted return is considered appropriate for a portfolio of mainly operational and lower risk UK infrastructure assets.

## **2.9 Exit**

As with DCF4, the CIF will have an investment term of 15 years, although this may be extended by up to 2 years by the Manager.

## **2.10 Fees**

The Management Fee for the CIF is based on the invested capital only (i.e. no fee is applicable until the funds are invested), with the rate comparing favourably with typical fee structures experienced by DIP in

the general infrastructure sector. A Carried Interest provision also applies to the CIF but at a lower level than applying to DCF4.

Overall the fee structure for the CIF is considered attractive.

## 2.11 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.

## 2.12 Investment Size and Cash Requirements

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

## 2.13 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 DCF4), based on Fund values at 30<sup>th</sup> 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 in DIP, as % 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:* See section 2.11  
*Social, including opportunities under Article 20 of the European Public Procurement Directive:* See section 2.11

*Economic:* See section 2.11

**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 SPF Co-investment Fund 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.