



Glasgow City Council

Strathclyde Pension Fund Committee

Report by Richard McIndoe, Director of Strathclyde Pension Fund

Item 5(a)

2nd June 2021

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**Direct Investment Portfolio (DIP)
Investment Proposal – SEP VI**

Purpose of Report:

To set out a proposal for an investment of £30m within the Direct Investment Portfolio.

Recommendations:

The Committee is asked to **APPROVE** an investment of £30m in **SEP VI** 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 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: £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 by the Sounding Board to the Committee.

2 New Investment Proposal

2.1 Key Terms

Name	SEP Fund VI
Investment vehicle	Scottish Limited Partnership
Manager	Scottish Equity Partners
Sector	Growth Capital
Investment objective	Targeting growth equity and venture capital investment opportunities predominantly in the information technology, energy and healthcare sectors primarily in companies operating in the United Kingdom and Ireland.
Term	10 years (plus up to 2x1 year extensions)
Target size	£350m
Proposed DIP investment	£30m
Target return	Internal Rate of Return (IRR) of > 20% (Net) and a multiple of 3x invested capital

2.2 Investment Summary

Scottish Equity Partners (“SEP”) is raising a new growth equity fund, SEP VI, to invest in the next generation of dynamic and ambitious founder-led technology companies in the UK and Europe.

SEP is a specialist growth equity investor with considerable expertise, knowledge and experience, as well as a powerful network of relationships across a range of disciplines and industry sectors. It has a long-term commitment to investment in the sector and a strong and consistent investment track record. Across the last five SEP funds raised since 2006, the aggregate net IRR is 21.5%.

SEP VI is being established as a ten-year Scottish limited partnership. The fund’s investment strategy will be consistent with previous SEP funds. The objective will be to achieve long-term capital growth through the careful and disciplined selection of a balanced portfolio of growth equity investments in high quality technology companies. The fund has a target size of £350 million and it is anticipated that it will make approximately 15 investments.

A commitment by the Direct Investment Portfolio of £30m to SEP Fund VI is proposed.

SEP is a signatory to the UN Principles of Responsible Investment.

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

2.3 Investment Rationale

The growth equity opportunity in the UK and European technology sector is significant and increasingly attractive. SEP believes that it brings much-needed business-building expertise to add value to the high growth potential companies it invests in and the network access to help them scale and internationalise.

The technology sector continues to demonstrate strong fundamentals, aided by its global reach and scale. Social and economic trends were already driving digitalisation and adoption of cloud-based software solutions and these trends have intensified further as a direct result of Covid-19, with both the step up in remote working and the increased urgency surrounding operational change. Organisations are seeking agility, new collaboration tools, improved operating efficiency and the real-time data necessary to manage the increased uncertainty.

SEP identifies companies that have similar and attractive growth characteristics – an attractive and growing market opportunity; a high calibre, data-driven team; a capital efficient and sustainable business model with strong unit growth; annual revenue growth in excess of 20%; strong financial controls; and a diversified customer base.

These shared characteristics have allowed SEP to develop a consistent and repeatable value proposition to these companies. It intends to maintain its current and historic approach of being actively involved with all portfolio companies, supporting them from the point of investment through to successful exit, in order to increase value and optimise fund returns.

SEP will typically invest £10 million to £30 million in each company, without leverage, taking minority stakes in founder-led, high growth companies.

2.4 Risks

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

- Sourcing Opportunities
- Portfolio Concentration
- Key Personnel

A summary of risks and key mitigants is included in schedule 2.

2.5 Projected Return

The target return for Fund VI is an IRR of 20% (Net) and a Multiple of Invested Capital of 3.0x. This is appropriate for a portfolio of this nature.

2.6 Exit

SEP VI has an investment term of 10 years although this may be extended with investors' agreement for up to 2 x 1 year extensions. The fund has a 5-year investment period although it is expected that the funds will be deployed well within this timescale.

2.7 Fees

The Management Fee is in line with DIP's experience in the current market for growth capital funds of this nature. It will be calculated on invested capital both during and after the investment period.

A Carried Interest (or performance fee) also applies. This is structured such that SEP require to perform strongly before they benefit under these provisions.

The alignment between SEP and investors is considered satisfactory by virtue of the proposed commitment by the SEP management team.

2.8 Environmental, Social and Governance Issues

SEP has been a signatory to the PRI (UN Principles of Responsible Investment) since 2020.

This reflects its commitment to build strong, resilient, and sustainable companies and its fundamental belief that there is a positive correlation between responsible practice and business growth. SEP encourages the companies it invests in to strive for best practice in all aspects of their activities, including being responsible businesses.

SEP was established and is based in Glasgow.

2.9 Investment Size and Cash Requirements

SPF Fund value at 31st March 2021	£26,176m
DIP allocation (target 5% of main fund) NAV	£ 1,309m
Current DIP NAV	£ 920m
Headroom v NAV	£ 389m

2.10 Investment Strategy

The proposed investment falls within the Growth Capital sector and therefore the Fund's Equity allocation.

Allocations following this investment, based on Fund values at 31st March 2021 and total DIP commitments to Equity, would be as follows

Equity, £ in DIP	£158m
Equity, % in DIP	9.5%
Equity in DIP, as % of Total Fund	0.6%
Equity, % Total Fund (target 52.5%)	61.1%

3 Policy and Resource Implications

Financial: Investment of £30m 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 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. No specific impact from this proposal.

Sustainability Impacts:

Environmental: See section 2.8
Social, including opportunities under Article 20 of the European Public Procurement Directive: See section 2.8
Economic: 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 £30m in **SEP VI** by the Direct Investment Portfolio.

Investment Manager: Scottish Equity Partners

SEP was formed in 2000 and has offices in London and Glasgow. The firm, which is led by its Managing Partner, Calum Paterson, is owned by its partners and professionally structured and resourced. SEP's culture is embraced by all its partners and employees and is based on trust, commitment and integrity, with a highly collaborative and professional work ethic.

SEP's senior team is highly skilled, combining strong sector knowledge and business-building experience, and has a proven track record in technology growth investing. The success of SEP's investment strategy is underpinned by the team's understanding of the technology sector and the business requirements for sustainable growth. The team has developed an extensive network and established an excellent reputation, with significant market visibility and credibility. Each of SEP's partners and executives has a high level of personal expertise and knowledge and their own valuable network. A strong team culture across the firm means that SEP benefits from the aggregation of this expertise and knowledge, and from the collective value of these networks. SEP also benefits from an exceptionally strong business operations team covering finance, investor relations, legal and compliance, marketing and human resource management.

SEP is committed to developing its people. All executives receive significant training, support and encouragement with a view to them achieving their career aspirations and fulfilling more senior roles in the firm over time. SEP is a signatory to HM Treasury's Women in Finance Charter.

Investment Specific Risks

Sourcing Opportunities

SEP has particular experience partnering with software, tech-enabled services and consumer internet businesses and expects this to underpin its approach to SEP VI. It will typically invest £10 million to £30 million in each company, without leverage, taking minority stakes in founder-led, high growth companies. This is entirely consistent with SEP's current investment model.

SEP has a relatively high profile in the market 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.

Portfolio concentration

There is intended to be a common focus to the portfolio, utilising the team's expertise in technological investments but these investments require to exhibit clear commercial opportunities allied to proven and established management teams. Within that core focus there will be a broad diversity of differing types of underlying business, as has been the case in previous funds.

Key Personnel

There will be 6 Key Persons who will include Calum Paterson, Andrew Davison and other partners of the Manager.

The success of SEP has been built on a strong core team and this has been maintained in recent years, with only a couple of senior retirements. There is sufficient strength and experience to deliver the strategy upon which the fund is predicated.