



Glasgow City Council

Strathclyde Pension Fund Committee

Report by Richard McIndoe, Director of Strathclyde Pension Fund

Item 4(b)

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**Direct Investment Portfolio (DIP)
Investment Proposal – Tosca Debt Capital Fund III**

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 **Tosca Debt Capital Fund III** 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	Tosca Debt Capital Fund III LP
Investment vehicle	English Limited Partnership
Manager	Tosca Debt Capital
Sector	Credit
Investment objective	To provide secured loans to UK regional businesses in the lower mid-market
Term	8 years (plus up to 2x1 year extensions)
Target size	£250m (Hard Cap £300m)
Proposed DIP investment	£30m
Target return	Internal Rate of Return (IRR) of 11% (Net) with a Cash Yield of 5% p.a.

2.2 Investment Summary

Tosca Debt Capital (TDC) is an independent private credit manager which was established in Manchester in 2015 as a direct lending platform for institutional investors with the support of Toscafund Asset Management.

TDC aims to generate attractive risk adjusted financial returns through direct lending to small and medium sized enterprises (SMEs) in the lower mid-market sector, mainly, but not exclusively in the regional markets of the UK and with a particular focus on the north of England.

TDC's third fund (Fund III) held a first close in November 2019 in the amount of £160m, which included commitments from British Business Bank (£50m), Cambridge Associates (£22m), Greater Manchester Pension Fund (£20m), Toscafund (£10m), the TDC management team (£1m) and a further £57m from various other institutional investors, family offices and individuals. Fund III's second (and final) close is scheduled for the second quarter of 2021 at which it is anticipated that c.£100m (possibly more) of additional funds will be raised.

An investment of £30m by DIP in TDC Fund III is now proposed.

DIP previously invested £30m in TDC Fund II. The performance of this fund is progressing well with a currently reported IRR of 9.7% and projected IRR of 10%+ (Net).

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

2.3 Investment Rationale

Following a material contraction in bank lending in the aftermath of the global financial crisis more than a decade ago, the availability of bank credit has remained very constrained, to the detriment of a significant segment of the UK's regional economies and the levels of employment that depend on it.

The lower mid-market (generally defined as companies with an enterprise value of up to £50m) has been particularly badly affected, mainly due to the regulatory

restrictions applied to banks, with the void increasingly being filled by private debt capital providers such as TDC.

TDC asserts that there is limited competition in the UK regional debt markets due to the majority of private debt capital providers being London based and focused on larger deal sizes (£25m+). The opportunities that TDC considers are therefore not subject to the same level of competitive pressure that exists at the larger end of the market. This allows potentially higher returns to be generated as well as a greater ability to exercise stronger levels of control, mainly in the form of financial covenants.

TDC proposes to deploy Fund III in the same targeted way as its previous fund, i.e. in unitranche, 1st, and 2nd lien loans.

Unitranche loans are loans which combine both:

- senior (or 1st lien) debt, which ranks higher in terms of security (and is therefore lower risk - typically provided by mainstream lenders/high street banks); and
 - subordinated (or 2nd lien) debt (lower security ranking/higher risk)
- in a single loan, as opposed to having two loans from separate lenders. The flexibility to undertake this type of loan was added to Fund II, having not been available in TDC's first fund.

Fund III's lending strategy will be very similar to Fund II, with the focus continuing to be on credit quality & leverage (the ratio of a borrower's total debt to EBITDA i.e. its earnings before interest, tax, depreciation & amortisation are deducted), which is typically no higher than a relatively modest four times.

As with its two previous funds, TDC will favour opportunities where relationships with introducers, intermediaries, private equity sponsors & other professionals (and therefore the level of insight & reference) are strongest.

The maximum loan hold size in Fund III, at £25m will be slightly higher than in Fund II (£20m), with an expected average of £15m (Fund II average £14m) across c. 20-25 investments. Fund I deployed its commitments of £86.5m in a portfolio of 10 investments, while Fund II has invested £256m to date (of total commitments of £261m) in 19 investments.

Through its first two debt funds, TDC's differentiated regional focus has resulted in strong levels of opportunities and strong investment returns.

2.4 Risks

The main risks of the proposed investment in TDC Fund III are considered to be:

- Origination Risk
- Credit Risk
- Default Risk

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

2.5 Projected Return

TDC Fund III is targeting an Internal Rate of Return (IRR) of 11% (net) plus a cash yield of 5% p.a. This compares with the currently projected IRR of 10%+ (net) for Fund II.

The targeted return for Fund III is considered acceptable for this type of debt investment and the track record of TDC's first two funds suggests that the target return is achievable.

2.6 Exit

The Fund will have an 8 year term, which may be extended by up to 2 years, and a 3 year Investment Period (IP) commencing from the Fund's first close in November 2019. The Fund's underlying loans will typically have terms of between 4-6 years.

The proposed investment will be repaid through a combination of a running cash yield generated from the fund's interest and fee revenues, in addition to scheduled capital repayments (or earlier refinances).

2.7 Fees

The Management Fee is in line with DIP's experience in the current market for debt capital funds of this nature. It will be calculated on invested capital both during and after the investment period, which is more beneficial to investors than is typically the case.

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

The fee structure for Fund III is modestly lower / more favourable (to SPF) than the equivalent structure for Fund II and is therefore considered satisfactory.

The alignment between TDC and investors is considered satisfactory by virtue of the proposed £1m commitment by the TDC management team.

2.8 Environmental Social and Governance Issues

TDC actively incorporates ESG considerations at each stage of the investment process, from the initial appraisal and decision-making process to the regular consideration of ESG factors during the term of the debt facilities to borrowers.

TDC takes the issue of responsible lending very seriously and has firm lending policies and principles in place which bring transparency and consistency to its approach in this regard. These policies are considered and reviewed both during the investment process and also on an ongoing basis, in accordance with their wider underwriting and portfolio management policies.

TDC has been a signatory to the UNPRI (Principles for Responsible Investment) since April 2018 and incorporates these principles into the selection and ongoing management of its investment portfolio.

2.9 Investment Size and Cash Requirements

SPF Fund value at 31st December 2020	£25,460m
DIP allocation (target 5% of main fund) NAV	£ 1,273m
Current DIP NAV	£ 879m
Headroom v NAV	£ 394m

2.10 Investment Strategy

The proposed investment falls within the Credit allocation of the Fund and therefore the Fund's short term enhanced yield allocation (STEY).

Allocations following this investment, based on Fund values at 31st December 2020 and total DIP commitments to Credit, would be as follows:

Credit, £ in DIP	£205m
Credit, % in DIP	12.7%
Credit in DIP, as % of Total Fund	0.8%
STEY, % Total Fund (target 20%)	17.6%

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:
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 £30m in **Tosca Debt Capital Fund III** by the Direct Investment Portfolio.

Investment Manager

Tosca Debt Capital (TDC) was launched in 2015 with the support and backing of Toscafund Asset Management (Toscafund), a multi-asset fund manager with AUM (assets under management) of c. \$4bn. TDC shares common investors and back office support functions with Toscafund, while retaining independent credit sanctioning and strategic decision-making control.

TDC provides flexible debt capital to SMEs in transactional events such as acquisitions, shareholder re-organisations and growth capital & refinancing scenarios. In this way it seeks to enable investors to benefit from the continued strong demand for non-bank financing in the UK that TDC has experienced when originating investment opportunities for its first two debt funds.

Based in Manchester, TDC has a team of 11 experienced investment professionals with a combined 200+ years' of experience in the regional debt markets. Through its pipeline of opportunities and track record of deployment, TDC has demonstrated the success of its differentiated regional proposition, as well as its extensive relationships with banks, other financial intermediaries and the team's personal networks developed over 20-30 years within the region.

TDC is led by partners and co-founders, Gary Davison and Richard Williams:-

Gary Davison is Managing Partner and has over 30 years banking and advisory experience, funding and advising clients on a range of capital and debt related scenarios. His experience includes 20 years in corporate finance in the northern UK market which includes 7 years as a partner in EY, Chartered Accountants.

Gary is responsible for leading TDC's strategy, fundraising and client relations and as head of the Firm's Investment Committee, plays an important role in deal structuring and portfolio management.

Richard Williams is a Partner in TDC and is a CA with 17 years' experience in the northern UK market with both EY and through various international and corporate secondments, his strengths being in transactions, mergers & acquisitions and debt advisory roles.

The partners are additionally supported in an advisory capacity by:-

David Allanson – former Regional Director (North of England), Lloyds Banking Group

Simon Allport – former Managing Partner (North Region), EY

TDC is regularly recognised at various funding and deal-making awards in both the north of England regions as well as on a national basis. The Firm is authorised and regulated by the Financial Conduct Authority.

Investment Specific Risks

Origination Risk

TDC is now very well established in the north of England and continues to experience strong levels of demand for direct / private debt funding, with the non-bank lending market for financing becoming increasingly prevalent in response to the continuing reduction in lending being experienced from the mainstream banking sector.

Since its formation, TDC has received a constant flow of high quality introductions in respect of up to 400 potential borrowers with an estimated deal value of over £3bn of which they have completed 29 investments with a value of nearly £350m.

Opportunities are sourced both on a direct basis through the strong personal local networks of the partners and also via intermediaries, such as accounting firms, corporate finance and private equity offices, as well as direct from banks themselves.

Credit Risk

The main risk is considered to be the risk of default of the counterparties (i.e. the borrowers) of the underlying debt investments.

This is mitigated in the first instance by TDC's extensive pre-investment appraisal and due diligence processes, which include an analysis of the source of the introduction and TDC's prior experience (and the reputation) of the stakeholders, the credit fundamentals of the proposed lending and the existence of multiple refinance exit route options for the investment in all potential downside scenarios.

Default Risk

The default risk is further mitigated by the granting of a comprehensive security package from investee companies and the inclusion of an appropriate suite of financial covenants to enable the early identification of adverse developments and the implementation of appropriate remedies. TDC are particularly proactive in this respect.

The successful track records of Funds I and II to date in this respect provides comfort in respect of TDC's debt underwriting and loan portfolio management capabilities.