



Glasgow City Council

Strathclyde Pension Fund Committee

Report by Richard McIndoe, Director of Strathclyde Pension Fund

Item 4(a)

1st March 2023

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Direct Impact Portfolio (DIP)
Investment Proposal – Capital Dynamics Clean Energy UK Fund

Purpose of Report:

To set out a proposal for an investment of £60m within DIP.

Recommendations:

The Committee is asked to **APPROVE** an investment of £60m in Capital Dynamics Clean Energy UK Fund by DIP.

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 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	Capital Dynamics Clean Energy UK Fund
Investment vehicle	Luxembourg Special Limited Partnership
Manager	Capital Dynamics Limited
Sector	Renewable Energy
Investment objective	Investing in clean energy technologies including solar PV, onshore/offshore wind, hydro and electricity storage, electric vehicle and grid infrastructure.
Term	10 years (plus up to 3x1 year extensions with investor consent)
Target size	£600m
Proposed DIP investment	£60m
Target return	10-12% IRR (Net) / 6-8%+ Cash Yield

2.2 Investment Summary

Capital Dynamics is seeking to raise £600m for the Capital Dynamics Clean Energy UK Fund (CE UK) to facilitate the acquisition and construction of a portfolio of clean energy projects.

The Manager will mainly focus on investments in wind, solar and battery storage assets in the following core markets, but may invest on a limited basis in other markets such as continental Europe where appropriate:

- United Kingdom (85%+);
- Republic of Ireland.

The CE UK fund has been awarded Article 9 ('Dark Green') Fund status. This a designation which can only be applied to a fund that has sustainable investment as its objective.

DIP previously invested £40m in Capital Dynamics' predecessor fund, which has the same strategy as the CE UK fund. This investment is performing well.

An investment of £60m by DIP in the Capital Dynamics CE UK fund is now proposed.

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

2.3 Investment Rationale

As active participants in the renewable energy market since 2010, the portfolio managers at Capital Dynamics (CD) have a strong pipeline of identified opportunities in the clean energy sector, capitalising on the high and growing demand for new, renewable energy infrastructure in the UK and Ireland driven predominantly by:

- European government commitments to reduce carbon emissions;
- UK and EU binding net zero objectives, targeting net zero emissions by 2050;
- increased corporate demand for sourcing energy from renewable sources under their own net zero and corporate social responsibility commitments;
- the need for energy security following the surge in energy prices following the pandemic and the conflict in Ukraine and the need to reduce reliance on gas imports from external markets;
- the increasing adoption of battery storage and other grid infrastructure as a result of declining costs and improved efficiency of the technology;
- the increasing commercialised nature of green hydrogen as an alternative fuel to natural gas; and
- technological innovation in the transportation sector (such as electric vehicles) increasing the demand for electricity from renewable sources.

The fund will seek to invest in clean, low-carbon and renewable energy projects that reduce or offset greenhouse gas emissions generating both energy commodities (e.g. electricity) and environmental credits. Investments will encompass mainly controlling stakes in individual assets and/or special purpose companies.

It is anticipated that 80%+ of the fund will be invested into traditional solar, wind and/or battery storage assets at a late-stage development and construction ready phase. The Manager however may also, on an opportunistic basis, acquire renewable energy assets which are either underperforming, or available at attractive prices where they consider that they can add value.

CD have identified an initial exclusive pipeline of 10 onshore wind, solar and battery storage opportunities for the CE UK fund, comprising 6 projects in Scotland, 2 in England and 2 in Wales. This approach is line with their longstanding strategy of identifying and securing opportunities prior to raising the required capital.

2.4 Risks

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

- Operational Risk
- Sector Specific Risk
- Regulatory or Legislative Risk
- Energy Prices

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

2.5 Projected Return

CD are targeting a return of 10%-12% IRR (Net) and a cash yield of 6-8%+ p.a. for assets when they become operational. This is considered an appropriate target return for a fund seeking to acquire mainly post-development but pre-construction assets.

2.6 Exit

The fund will have a term of 10 years, comprising a 4-year investment period (IP) and a 6-year holding period. It is expected there may be the potential for attractive exits based on the growing appetite in the market for de-risked, fully operational, renewable energy assets. Potential exits will be considered on an opportunistic basis.

2.7 Fees

The Management Fee is modestly lower than DIP's experience of other Renewable Energy funds. The fee will be calculated on committed capital during the IP and thereafter on the invested capital, which is in line with market practice.

Carried interest provisions also apply. These are structured such that Capital Dynamics, as manager requires to perform strongly before it benefits under these provisions.

The fee structure for the Capital Dynamics Clean Energy UK Fund is in line with DIP's experience for a fund of this nature in the renewable energy market and is therefore considered acceptable.

2.8 ESG and Impact

As an early adopter of ESG principles in the private markets, CD recognises the important role that alternative asset managers can play in leading the transition to a net zero economy. As climate change accelerates, setting a clear focus on greenhouse gas reduction targets in line with the 1.5°C objective will play a critical role in minimising environmental-related financial risk to its portfolio companies.

CD has pledged to commit to net zero with the Net Zero Asset Manager initiative – an international group of over 230 asset managers committed to supporting the goal of net zero greenhouse-gas emissions by 2050 or sooner. Net zero is the target of reducing greenhouse-gas emissions to the lowest possible levels and implementing methods of absorbing the remaining emissions from the atmosphere so that net emissions are zero.

The fund was recently awarded "Article 9 'Dark Green' Fund" status. This relatively new classification of renewable energy funds was introduced by the European Commission under its Sustainable Finance Disclosure Regulations and seeks to raise standards and improve transparency in the market for sustainable investment products and to avoid the effects of "greenwashing".

CD combines demonstrated returns with market leading ESG practices.

More information on the investment manager's approach to ESG and Impact is included in **Schedule 3**.

2.9 Investment Size and Cash Requirements

SPF Fund value at 31 st December 2022	£26,970m
DIP allocation (target 5% of main fund) NAV	£ 1,349m
Current DIP NAV	£ 1,349m
NAV Range (Lower) 2.5%	£ 675m
NAV Range (Upper) 7.5%	£ 2,023m

2.10 Investment Strategy

The proposed investment falls within the renewable energy sector and therefore the Fund's LTEY allocation. LTEY is a key area of investment focus for DIP.

Allocations following this investment, based on Fund values at 31st December 2022 and total DIP commitments to renewable energy, would be as follows:

Renewables, £ in DIP	£571m
Renewables, % in DIP	29%
Renewables in DIP as % of Total Fund	2%
LTEY, % Total Fund (target 20%)	18.4%

3 Policy and Resource Implications

Resource Implications:

<i>Financial:</i>	Investment of £60m to be drawn as required. Fee structure is considered to be moderately lower than market.
<i>Legal:</i>	The investment will be subject to satisfactory completion of due diligence, including review and execution of appropriate legal documentation.
<i>Personnel:</i>	None
<i>Procurement:</i>	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:

<i>Does the proposal support the Council's Equality Outcomes 2021-25? Please specify.</i>	Equalities issues are addressed in the Fund's responsible investment policy.
<i>What are the potential equality impacts as a result of this report?</i>	None
<i>Please highlight if the policy/proposal will help address socio-economic disadvantage.</i>	None

Climate Impacts:

<i>Does the proposal support any Climate Plan actions? Please specify:</i>	Yes - Capital Dynamics (CD) has been a signatory to the PRI (UN supported Principles for Responsible Investment) since 2008. This is consistent with Strathclyde Pension Fund's
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Climate Change strategy, which is being developed in line with Item 34 of the Council's Climate Action Plan.

CD has pledged to commit to net zero with the Net Zero Asset Manager initiative – an international group of over 230 asset managers committed to supporting the goal of net zero greenhouse-gas emissions by 2050 or sooner.

What are the potential climate impacts as a result of this proposal?

A meaningful contribution to the additional renewable energy (RE) generating capacity required for the UK to become net zero by 2050.

Will the proposal contribute to Glasgow's net zero carbon target?

Yes - through the development and construction of additional RE generating capacity across the UK, including a number of projects in Scotland.

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 £60m in Capital Dynamics Clean Energy UK Fund by the Direct Impact Portfolio.

Schedule 1
Schedule 2
Schedule 3

Investment Manager: Capital Dynamics Limited
Investment Specific Risks
Impact and ESG

Investment Manager: Capital Dynamics Limited

Capital Dynamics (CD) is an independent global asset management firm focusing on private assets including clean energy, private equity and private credit. Created in 1988, the firm has extensive knowledge and experience raising closed-ended funds and developing solutions tailored to meet the exacting needs of a diverse and global client base of institutional and private wealth investors. As of Q1 2022, CD managed or advised on over \$13 billion of assets.

The firm currently has 14 offices located in major financial centres worldwide and has over 160 employees. Its wealth of international experience is an important resource in assessing investment opportunities, evaluating managers and funds as well as servicing its clients worldwide.

CD's Clean Energy division is one of the largest renewable energy investment managers in the world with one of the longest track records in the industry. The clean energy strategy was established to capture attractive investment opportunities in the largest and fastest growing sector of global infrastructure – proven renewable energy technologies, with a focus on utility-scale and distributed generation, solar and wind. The platform's asset management affiliate (Netro Energy) provides highly specialised services to help ensure optimal performance and value from projects.

The team at CD can offer clients a full range of clean energy products, including in solar, wind and battery storage. The CE UK fund will invest directly in commercial, clean and low-carbon power generation assets and related infrastructure. The programme's focus is on proven technologies. The firm's experienced team seeks investment opportunities in operational, construction-ready, and late-stage development assets. The team has extensive experience in investing in solar, wind, land-fill gas, natural gas-fired generation, and biomass projects.

CD's Clean Energy Infrastructure Team comprises 14 professionals who are based in the firm's London offices with combined experience in the renewable energy sector of 135 years. Established in 2010, the CE Team manages a dedicated CE platform with AUM over \$3.2 billion (£2.6 billion).

The Fund Manager, Capital Dynamics Limited, is authorised and regulated by the UK Financial Control Authority (FCA)

Investment Specific Risks**Operational Risk**

There is always a risk that assets will not perform as forecast due to technical or operational issues caused by weather or other factors. To mitigate this risk, CD aim to construct a portfolio which is diversified by both geography and technology and directly employ sector specialists to remotely monitor the performance of the assets. The ongoing repair and maintenance obligations on the portfolio are undertaken by external contractors and speed of response/rectification is critical in minimising operational downtime and therefore revenues. Wind turbines incorporate manufacturers' warranties covering minimum availability performance levels and typically incorporate insurance policies for underperformance.

Sector Specific Risk

Clean energy projects are long-term assets with economic lives often exceeding 20 years. The performance of each asset will be dependent upon wind, solar and/or rainfall conditions at each site, which by their nature are unpredictable from year to year and can potentially affect electricity generation levels and ultimately revenues. Over the long term however weather conditions and therefore asset revenues will tend towards long term averages. An important part of CD's due diligence process is to carefully consider the long-term energy generation expectations of each asset.

Regulatory or Legislative Risk

Renewable energy proposals in the past had the benefit of being underpinned by a wide-ranging government renewable energy subsidy regime, although this was widely reduced in scope around 4 or 5 years ago. Since then, alternatively structured subsidy schemes have been reintroduced and CD will take advantage of these where appropriate.

There is however greater reliance on the strength of the Power Purchase Agreements (PPAs) with suitable, high-quality counterparties to reduce the market risk of fluctuating energy prices. In practice CD will adopt a balanced approach to mitigating the risk of energy price volatility.

Energy Prices

Increasing global demand coupled with energy supply shocks from extreme weather events, trade disruption and the conflict in Ukraine has led to a sharp rise in power prices over the past 12 months or so. Rising corporate PPA prices provide upside by mitigating volatility, increasing project value and financing cost risk. CD have a strong track record of effectively managing the downside risk as demonstrated in their previous fund in which DIP invested.

ESG and Impact

Capital Dynamics makes direct equity investments in carbon-reducing renewable power and energy storage projects, with the goals of reducing reliance on carbon-emitting fossil fuels, providing affordable clean energy, and creating jobs during the construction period of projects. The investments to be made by the fund will support the following sustainable investment objectives:

Environmental objectives:

- climate change mitigation;
- climate change adaptation;
- pollution control and prevention;
- protection and restoration of biodiversity and ecosystems.

Social objectives:

- job creation;
- worker health and safety.

Governance objectives:

- tackling diversity;
- tackling corruption.

CD can demonstrate impact across existing funds in the form of:

- 27.9 million metric tons of GHG (Green House Gas) emissions avoided since inception of Clean Energy business;
- 4.7 million homes powered since inception of Clean Energy business;
- 100% of office energy from renewable sources;
- 600 construction jobs created since the start of the pandemic;

Net Zero pledge:

In April 2022, Capital Dynamics committed to driving actionable change on GHG emissions by signing the Net Zero Asset Managers initiative and joining the Partnership for Carbon Accounting Financials. The implementation of a 5-Year Climate Plan will allow the firm to take immediate action towards cutting financed GHG emissions and demonstrate an early commitment to a net zero pathway.