



Glasgow City Council

Strathclyde Pension Fund Committee

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Item 4(b)

1st March 2023

Direct Impact Portfolio (DIP)
Investment Proposal – Corran Environmental Fund II

Purpose of Report:

To set out a proposal for an investment of £20m within DIP.

Recommendations:

The Committee is asked to **APPROVE** an investment of £20m in Corran Environmental Fund II 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	Corran Environmental Fund II
Investment vehicle	Scottish Limited Partnership
Manager	Corran Capital LLP
Sector	Growth Capital
Investment objective	To invest in UK based businesses in the clean energy, environmental & sustainability sectors
Term	8 years (plus up to 2x1 year extensions)
Target size	£110m
Proposed DIP investment	£20m
Target return	20% IRR (Net) / 2.5x-3.0x Multiple

2.2 Investment Summary

Corran Capital (Corran or the Manager) is a growth capital firm which is focused on the clean energy sector. It was formed by highly experienced renewable energy, growth (and venture) capital specialists with strong track records.

The Corran Environmental Fund II (CEF2 or the fund) will be seeking to invest in the clean energy and environmental sectors, targeting assets that will promote de-carbonisation and help deliver net zero strategies.

CEF2 is seeking to raise £110m from 4/5 investors, for deployment in the UK in one large (secondary) asset in the heat sector and 4-6 smaller (primary) investments in the clean energy, sustainability and environmental sectors.

An investment of £20m by DIP in CEF2 is proposed.

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

2.3 Investment Rationale

2.3.1 UK Renewable Energy (RE) Requirements

In 2019 the UK Government amended the Climate Change Act 2008 to commit the UK to achieving net zero emissions by 2050.

Scotland has been relatively successful in decarbonising the electricity sector. In 2021 the vast majority of electricity generated in Scotland was generated from either renewable (c.57%) or low carbon (c.31%) sources. In terms of all forms of energy however, Scotland consumes more than twice as much energy in the form of gas (mainly for heating) than it does in the form of electricity, with gas being used to heat 85% of homes and 65% of non-domestic buildings.

This serves to reduce Scotland's total energy consumption generated from renewable sources to just c.27%. With gas accounting for c.37% of all UK

carbon emissions, the opportunity for some of the larger decarbonisation gains within the UK's energy system therefore lies within the heat sector.

District Heat Networks (DHNs) connect local, decentralised sources of heat generation with heat consumers, in the form of residential areas, businesses, or campus-based organisations such as hospitals, universities etc, through networks of insulated distribution networks delivering heat to end users.

The UK currently has c.14,000 DHNs serving c.480,000 consumers which currently accounts for c.2% of the UK's heating requirements. While this is projected to increase to up to 20% by 2050, at current levels of adoption, it is some way behind other countries such as Germany (12%), Finland (49%) and Denmark (60%) where it is a well-established technology.

The Committee on Climate Change estimates that DHNs alone could reduce the UK's carbon emissions by 5.7MtCO₂ by 2030.

DHNs can be retro-fitted into existing buildings however this is more challenging and less cost-effective than incorporating the systems at the design stage of new development projects.

Heat sources for DHNs were historically based on traditional gas boiler systems, however, have rapidly transitioned to more energy-efficient, gas-fueled, combined heat and power (CHP) plants and again more recently to more sustainable technologies such as heat pumps (air, ground or water sourced) and/or solar/geothermal sources. The optimal source however, is the capture of waste heat from industrial, commercial, energy from waste (EfW) and/or biomass processes.

2.3.2 Fund Strategy

The cornerstone investment in CEF2 is proposed to be the acquisition of a large minority stake in a leading, UK based DHN and sustainable energy solutions business.

In addition, Corran receives significant inbound deal flow opportunities across the clean energy, infra-tech, sustainability and environmental sectors from which they envisage investing £5-£10m across 4-6 new investments. The fund will target growth stage companies demonstrating strong commercial progress in the clean energy; energy efficiency; renewable heat; recycling/resource efficiency, water/waste-water treatment; asset optimisation opportunities and transport/EV sectors amongst others.

2.3.3 Cornerstone Investment

The cornerstone investment will be in a company which is widely accepted to be an established market leader in the UK's DHN/sustainable energy solutions sector. It delivers turnkey energy solutions to a diversified public and private sector customer base, including 64 university and hospital projects over the past 6 years and more than a dozen hospital, university and residential DHN projects in Scotland. It has a significant, 9-figure annual turnover which has grown at an average of c.18% p.a. over the past 12 years; is highly profitable;

is a significant UK employer and has an order book in excess of two years' current sales.

The businesses' main activities are in i) the design, build & operation of energy efficient heat/power generation & distribution systems (i.e. DHNs); ii) long term energy efficiency/performance contracts allowing clients to achieve energy efficiencies and reduce carbon emissions; and iii) the development (for long term operation and ownership) of EfW projects in England, including one which is well advanced.

A relatively large proportion of CEF2 (£70m or c.65% of the fund's target size) is to be allocated to this company. The majority of this amount will be for the initial acquisition of the stake and the sizeable remainder held in reserve on an uncommitted basis for investment in follow-on developed/owned projects, to be assessed on a case-by-case basis by Corran.

The proposed cost of the stake has been externally validated for each party by independent advisers with significant heat, DHN and EfW sector experience. The proposed price is also supported by a (rejected) third party offer for the stake nearly 2 years ago.

The principal behind Corran is Gary Le Sueur, who was a founder partner of Scottish Equity Partners (SEP). He personally managed the SEP Environmental Capital Fund (SEP ECF) in which DIP invested £5m in 2014 and on which CEF2 is closely modelled, incorporating as it does a large cornerstone (secondary) asset, complemented by 4-6 other primary investments in the clean energy sector. He has had a direct involvement within the heat sector for 10+ years and therefore has a very good knowledge of the business and the sector the company operates in, while his Corran co-partner has had an even longer involvement in the sector. Both partners are familiar with the cornerstone asset.

2.4 Risks

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

- Origination Risk
- Concentration Risk
- Key Personnel

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

2.5 Projected Return

The Manager is targeting a return of 20% IRR (Net) and a MOIC (Multiple on Invested Capital) of 2.5-3.0x. While the fund is targeting the clean energy, environmental and sustainable sectors, it is a growth capital fund and accordingly, the targeted returns are more in line with what would be expected for the growth capital sector than for a traditional renewable energy fund.

2.6 Exit

The fund will have a basic term of 8 years, comprising a 4-year Investment Period (IP), followed by a holding period of up to 4 years, subject to 2x1 year

extensions. The repayment of capital and investment returns however are expected from asset realisations after typical holding periods of 3-5 years.

2.7 Fees

The level of the Management Fee is lower than DIP's experience of the growth capital market while its structure is also considered beneficial to investors.

Carried interest (or performance related) provisions also apply to the fund. These will be structured such that Corran, as manager will require to perform strongly before it benefits under these provisions.

The level and structure of the fees for the CEF2 fund are generally lower or more beneficial, than DIP's experience for a fund of this nature in the growth capital sector and are therefore considered attractive.

2.8 ESG and Impact

DIP's investments in the growth capital sector normally focus on the social aspects of the jobs created by growth businesses and while this is also true for CEF2, the main impact created by the fund will be more environmental in nature. This will specifically be in the form of reduced carbon emissions through the investment in the DHN business, the projects this company delivers for its clients and the assets (e.g. EfW) it will be developing in the future. The impact of the smaller primary investments will be additional to this.

More information on the 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 Growth Capital sector and therefore the Fund's Equity allocation. Equity 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 Equity, would be as follows:

Equity, £ in DIP	£278m
Equity, % in DIP	14%
Equity in DIP % of Total Fund	1%
Equity, % Total Fund (target 52.5%)	56.0%

3 Policy and Resource Implications

Resource Implications:

Financial: Investment of £20m to be drawn as required. Fee structure is modestly lower than 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: 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:

Does the proposal support the Council's Equality Outcomes 2021-25? Please specify. Equalities issues are addressed in the Fund's responsible investment policy.

What are the potential equality impacts as a result of this report? No significant impact from this proposal.

Please highlight if the policy/proposal will help address socio-economic disadvantage. Growth capital funds, assuming successful, should result in additional employment opportunities in their respective locales.

Climate Impacts:

Does the proposal support any Climate Plan actions? Please specify: The CEF2 fund anticipates contributing to the decarbonisation of the UK's heating sector. This is consistent with Strathclyde Pension Fund's Climate Change strategy, which is being

developed in line with Item 34 of the Council's Climate Action Plan.

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

A reduction of carbon emissions in respect of each of its investments and in particular from the UK heat sector.

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

Yes, through a reduction of carbon emissions resulting from each of the fund's investments.

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 £20m in Corran Environmental Fund II by the Direct Impact Portfolio.

Schedule 1
Schedule 2
Schedule 3

Investment Manager: Corran Capital
Investment Specific Risks
ESG and Impact

Investment Manager: Corran Capital

Corran Capital was established by **Gary Le Sueur** in 2020 following his partial/amicable exit from Scottish Equity Partners (SEP) to focus on growth capital investments in the clean energy, environmental and sustainability sectors, which are no longer a core sector for SEP, but to which he remains committed.

Le Sueur is well known to DIP having been a founder partner of SEP, with whom DIP has made commitments to 6 separate funds over the past 12 years or so, including £5m to SEP Environmental Capital Fund (SEP ECF). This fund, and its predecessor (in which DIP was not invested), were both managed by Le Sueur and it is on these funds that CEF2 is modelled. Both these environmental funds performed very well for investors.

The other investments in the mainstream SEP funds included some of DIP's earliest (and more modest) commitments, with the more recent ones increasing in size to £20m/£30m each. All have performed very well to date.

Corran's first fund (CEF1) raised £48m from SSE plc to establish Renewco Power, a solar, wind & storage developer focused in Europe/US (in which DIP is not invested).

CEF2 is seeking to raise £110m from a small number of investors for deployment in the UK. Corran is at a similar stage in the fundraising process with 4 other institutional investors who invested previously in SEP.

At Corran, Gary Le Sueur will be supported by a small team of key partners / directors including:-

Derrick Allan (Partner) has extensive knowledge of the UK and European energy sector having been involved in this market for over 30 years. He has a successful track record in developing new concepts into businesses opportunities, leading organisations through change, growth phases and achieving successful exits.

His initial career was spent at SSE plc where he ultimately became Head of Ventures and responsible for the acquisition and development of commercial ventures including SSE's venture portfolio of companies. He later held positions as Director, Non-Executive and Chairman of various energy related companies.

Lucy Graham (Investment Director) qualified originally as a lawyer, practicing within corporate finance for 10 years before taking up a senior position within the Clydesdale/Yorkshire Bank Group in their Corporate Finance section, ultimately becoming Senior Corporate Finance Partner advising the CYB board on acquisitions, joint ventures, strategy and divestments for the group.

She then moved on to join Cairngorm Capital, a mid-market private equity fund, where for the past 5 years she was a senior member of the investment team, responsible for originating and executing opportunities and for portfolio management.

Investment Specific Risks

Origination Risk

The proposed cornerstone investment in the DHN business is clearly fundamental to the fund's strategy. CEF2 has exclusivity in terms of the acquisition, subject to final agreement of the cost and terms of the stake and funding being available. DIP's proposed commitment to the fund is subject to this transaction completing. In the event it doesn't complete for any reason, DIP's investment in the fund will not proceed.

The balance of the CEF2 fund (£40m) will be allocated for smaller, primary investments in clean energy, environmental and sustainable businesses, and is anticipated to be deployed in 4-6 investments of £5m-£10m each.

As longstanding active participants in the clean and renewable energy market, Corran's principals receive significant in-bound potential opportunities in these sectors. They therefore have access to more than sufficient numbers of opportunities to deploy the allocation. The origination risk is therefore considered to be low.

Concentration Risk

The c.65% (£70m) allocation to the DHN business, is a large concentration in a single asset for a fund of CEF2's size. It should however be noted that while a majority of this amount will be committed at the outset, a sizeable minority will be uncommitted and deployed into the company over time, subject to suitable commercial opportunities arising which will be appraised on a case-by-case basis by Corran prior to being committed.

This is the same model that was successfully utilised by Gary Le Sueur in the two environmental funds he managed at SEP, both of which generated very attractive returns.

The principals of Corran are committing significant personal funds into CEF2 to ensure strong alignment with investors.

Key Personnel Risk

Gary Le Sueur is the main driving force behind the Corran business, although he has a collaborative approach as demonstrated by his two decades at SEP and the team he has assembled in respect of Corran's maiden fund (CEF1) in the establishment of the Renewco business funded by SSE plc.

He has adopted a similar approach in respect of Corran Capital by recruiting Derrick Allan and Lucy Graham, both very senior and experienced appointments with others intended to follow into the team as the business develops, thereby mitigating the key personnel reliance on himself.

Impact and ESG

Corran Capital was formed in 2020 to provide investment in high quality UK businesses across the clean energy, sustainability and environmental sectors. The firm was founded with the core purpose of helping to accelerate the deployment of institutional capital in high potential, early stage, privately owned UK companies with low carbon and net-zero business strategies. At the firm's core therefore is a strong focus on delivering environmental and societal benefits.

The firm defines its mission as “helping leaders in the clean energy and environmental sectors grasp the opportunities presented by climate change and to grow valuable businesses in a successful and sustainable manner”. The firm's approach is based on the premise that market economics is the best way to create value however needs a social impact to be credible.

Corran Capital is managed by experienced investment executives based in Scotland with a long and successful track record of building companies with strong ESG credentials. The firm considers its impact and ESG values throughout its operations and investment process and aims to play a material role in delivering related benefits to investors, investee companies and society more broadly.

The firm is committed to managing, measuring and reporting its contribution to sustainable development and, as a relatively young firm raising its first significant institutional fund, is considering the best approach to implement this in a practical and valuable manner while not burdening its operations or those of investee companies.

Corran anticipates following the approach used successfully by its founder in his previous firm (SEP), which appointed an independent ESG consultant to optimise its approach to Impact. It also intends to expand its ESG credentials as the firm grows, including likely participation with the BVCA and becoming a signatory to the UN supported Principles for Responsible Investment.