



Glasgow City Council
Strathclyde Pension Fund Committee

Item 5(a)

2nd March 2022

Report by Richard McIndoe, Director of Strathclyde Pension Fund

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**Direct Impact Portfolio (DIP)
Investment Proposal – Palatine Impact Fund II**

Purpose of Report:

To set out a proposal for an investment of £25m within DIP.

Recommendations:

The Committee is asked to **APPROVE** an investment of £25m in **Palatine Impact 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 review. 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 name change from the Direct Investment Portfolio 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 (DIP)	
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.

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	Palatine Impact Fund II
Investment vehicle	English Limited Partnership
Manager	Palatine Private Equity LLP
Sector	Growth Capital
Investment objective	Investing in high growth areas of healthcare, sustainability and training in the UK.
Term	10 years
Target size	£200m (Hardcap £250m)
Proposed DIP investment	£25m
Target return	15% IRR (net); 1.5x multiple

2.2 Investment Summary

Palatine is a Manchester-based, regionally focused, UK lower mid-market Private Equity investor controlled and owned by its partners who, together have over 80 years' experience of sourcing, executing and managing businesses in the UK.

Palatine Impact Fund II LP (Fund II) is an English limited partnership with a target fund size of £200 million. Fund II intends to continue Palatine's proven approach to make investments in small and medium sized companies across the UK that demonstrate a clear social or environmental benefit. The fund expects to make 10-12 investments, generally of between £5 million and £20 million.

A number of other institutional investors are currently undertaking due diligence and working towards first close in February including a combination of UK public and private pension funds and European fund of funds. Total estimated commitments at this stage is £100m+. There are also a number of LGPS, Insurers, consultants and Family Offices in further due diligence, working towards a close in Q2 2022.

Palatine are regularly recognised as industry leaders for ESG management. Portfolio companies are extremely engaged with the ESG system and support they receive.

An investment of £25m by DIP in Palatine Impact Fund II is proposed.

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

2.3 Investment Rationale

Palatine Private Equity is an independent private equity firm managed by its partners, who are based in the target regions and are the decision-makers within the firm. Unlike private equity houses seeking to source and execute deals in these regions from a London base with or without regional satellites, Palatine is based in Manchester, a major financial centre in the North West of England.

Fund II will consist of investments that are commercially attractive because of the social and environmental benefits delivered by their business models. Palatine has identified four main investment themes informed by the trends and drivers resulting from social and environmental challenges currently facing the world: Sustainable Communities, Healthy Living, Environment, and Sustainable Choices. These themes provide an investment focus and strategic direction to maximise the positive impact from investments made by the Fund:

The firm's investment philosophy is to seek opportunities with the potential for "buy-and-build" expansion (either through bolt-on acquisitions or through rolling-out a business concept to different areas) and/or significant operational improvements. They also have a strong approach to ESG investment management, reflected in the firm winning multiple responsible investment awards in recent years. Palatine is one of the leading private equity firms in the environmental, social and governance space. They have been committed to sustainable investment for over 12 years. Palatine have a robust pre-deal to exit programme in place that is underpinned by an ESG policy and manual.

The Palatine Impact team is led by Beth Houghton, Managing Partner Impact Fund, who has successfully led Palatine's Impact Fund I and guided Palatine toward multiple responsible investment awards. Alongside Beth there are four other Partners, as well as Gary Tipper the managing partner and Tim Farazmand (Impact Fund Chairman).

These partners are supported by a wider team composed of a dedicated direct origination team, a value creation team, finance/admin team, and the three local investment teams in London, Birmingham and Manchester.

2.4 Risks

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

- Sourcing Opportunities
- Private Equity Risk
- Key Personnel
- Conflict of Interest

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

2.5 Projected Return

The target return for Fund II is an IRR of 15% (Net) and a Multiple of Invested Capital of 1.5x. This is appropriate for a portfolio of this nature.

2.6 Exit

Fund II has an investment term of 10 years. 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 time.

2.7 Fees

The Management Fee is typical of DIP's growth portfolio and of the current market. The fee will be calculated on total commitments during the IP and on the invested capital thereafter, which is in line with market practice.

Carried interest provisions also apply. These provisions are structured such that Palatine require to perform strongly before they benefit.

The management fees and carried interest provisions are in line with growth capital market norms. It is anticipated that Palatine will reach their £200m target fund raise.

2.8 ESG and Climate Change Impact

Palatine has been a signatory to the PRI (UN Principles of Responsible Investment) since 2014. Palatine believes that embedding ESG practices into their operations has never been a more critical element in creating a sustainable future. Managers strive to build sustainable businesses, which generate market rate returns and create long term value. They have a consistent track record of year on year transparent portfolio reporting and collaboration with management teams that enhances portfolio ESG performance.

2.9 Investment Size and Cash Requirements

SPF Fund value at 31 st December 2021	£28.633bn
DIP allocation (target 5% of main fund) NAV	£1,432m
Current DIP NAV	£1,174m
Headroom v NAV	£ 258m

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 2021 and total DIP commitments to Growth/Venture Capital, would be as follows:

Growth/Venture Capital, £ in DIP	£233m
Growth/Venture Capital, % in DIP	13.1%
Growth/Venture Capital in DIP as % of Total Fund	0.81%
EQUITY, % Total Fund (target 52.5%)	60.6%

3 Policy and Resource Implications

Resource Implications:

Financial: Investment of £25m 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 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 specific impact from this proposal.

Please highlight if the policy/proposal will help address socio-economic disadvantage. No specific impact from this proposal.

Climate Impacts:

Does the proposal support any Climate Plan actions? Please specify: Palatine has been a signatory to the UNPRI (UN Principles of Responsible Investment) since 2014. 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? Palatine are signatories to the IIGCC and initiative climate International. In all investments the carbon footprint of portfolio companies are measured and climate impact is looked to be improved during the hold period.

Will the proposal contribute to Glasgow's net zero carbon target? Potentially through the work of portfolio companies such as Anthesis who have a global client base as well as Tesco and Network Rail.

Privacy and Data Protection Impacts: To be fully provided for in the legal documentation for the proposed investment.

- 4 Recommendations**
The Committee is asked to **APPROVE** an investment of £25m in **Palatine Impact Fund II** by DIP.

Investment Manager: Palatine Private Equity

Palatine Private Equity LLP was founded in 2005 and is an independent private equity firm managed by the Partners that has raised c.£800 million to date across five funds. Palatine is based in Manchester and is one of a small number of established lower mid-market private equity houses with its head office located outside of London. Palatine also has offices in London and Birmingham

Palatine is led by Gary Tipper who has 25 years of experience investing in the UK regional LMM. Prior to establishing Palatine with partners Ed Fazakerley and Tony Dickin, he was Head of Limited Partnerships at AMJPE (Aberdeen Murray Johnstone PE) where all three worked together. Andy Lees who also worked at AMJPE, joined Palatine as a partner in 2013. Combined, the 4 partners have 80+ years of experience in regional PE.

Palatine believes that its regional focus presents it with certain advantages, namely fewer competitors, leading to lower competition for deals and reduced pricing pressure; strong relationships with locally based corporate finance advisers; and a partner-led model which together with their regional headquarters attracts local entrepreneurs who prefer business partners with local knowledge / presence.

Palatine has won several awards in recognition of its commitment to implementing and promoting Environmental Social and Governance ("ESG"). Palatine has also been included in a number of industry publications on best practice in ESG, including the BVCA Responsible Investment Guide and the Principles for Responsible Investment ("PRI") guide to ESG monitoring, reporting and dialogue in Private Equity. Palatine is one of the leading sustainable and impact investment managers and has developed a strong reputation in this market segment.

Investment Specific Risks

Sourcing Opportunities

The ability to originate a pipeline of attractive opportunities in the lower mid-market segment of the UK market is a key factor in the potential success of the fund. Palatine has a relatively high profile in the regional markets and consequently benefits from a steady flow of referrals from its network of contacts, traditional introducers and new office in Birmingham. There is no reason to believe this will not continue following the relative easing of the political uncertainty in the latter part of 2019.

Private Equity Risk

The proposed investment is into a PE fund, which operates in a relatively risky segment of the financial market with no guarantee of success. A PE fund would traditionally anticipate a number of outright investment losses, a larger number of moderately successful investments and one or two “stellar” investments, which combine to generate the blended / relatively high targeted return. The principal comfort in this regard is Palatine’s track record in its previous impact fund. Fund I portfolio companies E-days, Veincentre, TranScrip and Back2Work all have EBITDA margins over 20%. Palatine will then look to drive strong growth; the compound average revenue growth of companies in Fund I is 22.5% for those deals held for greater than 12 months.

Key Personnel

The risk of over-reliance on key personnel is pertinent to any manager and indeed Palatine consider that they were relatively under-resourced during a growth phase coinciding with their second fund and which partially contributed to the lower return for that fund. This was remedied well in advance of subsequent funds, and further recruitment is envisaged.

The success of Palatine has been built on a strong team comprising 4 partners (with over 80 years combined PE experience), 22 investment professionals plus further support functions. It is considered that there is sufficient strength and experience in the team to deliver the proposed strategy Impact Fund II.

Conflict of Interest

The Palatine Impact Funds may have potential conflicts with Palatine’s Buyout Funds, given the fund size and as the equity size increases. Given the specific focus of Impact Fund II to identify investment opportunities that have a clear and measurable impact on society and/or the environment, Palatine do not foresee there to be many occasions where either investment teams might compete for the same deal.

Palatine have a clear mechanism for determining the allocation of deals between the Buyout funds and the Impact funds and have devised a clear scoring mechanism for investment teams to follow, to identify the level of Impact the target business delivers and therefore which fund the investment would most appropriately be allocated to.