



Glasgow City Council

Strathclyde Pension Fund Committee

Report by Richard McIndoe, Director of Strathclyde Pension Fund

Item 4

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**Direct Investment Portfolio (DIP)
Investment Proposal – Foresight Regional Investment Fund, Scotland**

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 the Foresight Regional Investment Fund, Scotland 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	Foresight Regional Investment Fund, Scotland
Investment vehicle	English Limited Partnership
Manager	Foresight Group LLP
Sector	Growth/Replacement Capital
Investment objective	To create a diversified portfolio of unlisted growth-orientated SME investments in Scotland; to generate attractive returns for investors; and to deliver sustainable economic and social benefits as a result.
Term	10 years
Target size	£60m (Hard Cap £100m)
Proposed DIP investment	£30m structured as follows:- £20m subject to the fund securing a 1 st Close amount of at least £30m; plus an additional £10m subject to total commitments reaching £50m. Both totals to include SPF's commitment.
Target return	15% IRR (Net)

2.2 Investment Summary

The Foresight (FS) Regional Investment Fund, Scotland (FRIFS) is seeking to raise £60m for private equity (PE) investments of between £1m and £5m into Small and Medium Sized Enterprises (SMEs) located in Scotland. These investments will take the form of growth and/or replacement capital transactions including buy-outs.

The fund will be an extension of FS's proven regional investment strategy which is currently operating in 3 regions in England and which focuses on making similar sized investments to that proposed by FRIFS in Scotland.

Since July 2020, FS Group's Infrastructure division has managed the PIP (Pensions Infrastructure Platform) Multi-Strategy Infrastructure Fund in which DIP has a £130m commitment and their performance has been satisfactory to date in this respect.

A commitment by the Direct Investment Portfolio of £30m to the Foresight Regional Investment Fund, Scotland is proposed.

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

2.3 Investment Rationale

The FRIFS fund will target the SME market in Scotland, which in FS's view receives a disproportionately low level of growth capital investment, particularly in the targeted £1m to £5m segment of the market, compared with the rest of the UK. This is despite having a larger business base and strengths in technology, construction, business services and manufacturing/engineering.

While the businesses the fund aims to invest in will be growth orientated, they will be more traditional and/or mature in nature and character, as opposed to internet, digital or software based businesses.

FS consider there to be less competition in Scotland compared to their other regional funds, particularly within the fund's target investment range for growth and/or replacement capital opportunities and feel that this segment of the Scottish market is currently underserved and suitable for a fund of this nature.

DIP reviewed the FRIFS in 2019 however there were challenges over how FS would raise the remainder of the fund were DIP to make a commitment. At that time FS also didn't have a Scottish office or investment principals in place. Since then however they have secured a £20m Scottish Government investment mandate (the FS Scottish Growth Fund "SGF") in a similar, but earlier stage segment of the SME market.

The SGF fund has been used by FS as a platform to open an office in Edinburgh and recruit/establish a local investment team, which now comprises 2 investment professionals: Daniel Halliday (Senior Investment Manager) and Graeme McKinstry (Investment Manager) supported by the broader PE team based in London led by Russell Healey (Head of PE) and Matt Smith (Partner, PE team). According to FS, the hub and satellite structure is key to the successful operation of their regional fund model, as investment opportunities of the targeted size don't travel and require local teams embedded in the respective regions.

To date the Scottish team has deployed £13.5m of the SGF fund in 12 investments, alongside an additional £14m from co-investors. As a result FS now has an established profile in the Scottish business network and on the basis of this platform has targeted the relaunch of the FRIFS.

The types of opportunity considered most suitable for the fund include owner-managed businesses capable of growth but which may be constrained by management teams lacking the breadth or depth of experience to take the business to the next level. These businesses can often benefit from enhanced levels of expertise in respect of the sales or finance functions, operations and/or overall governance and FS will seek to assist them in these areas.

2.4 Risks

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

- Fundraising
- Sourcing Opportunities
- Private Equity Risk

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

2.5 Projected Return

The targeted return for the FRIFS is a net IRR of 15%. This is considered appropriate for a fund which is making equity investments in SMEs in more traditional and/or mature business sectors.

2.6 Exit

FRIFS has an investment term of 10 years with an investment period (IP) of 5 years. Repayment is expected to originate from the sale of the investments towards the end of the fund's life following a holding period of 3-7 years.

2.7 Fees

The Management Fee is modestly lower than DIP's experience in the current market for funds of this nature. It will be calculated on commitments during the investment period and on invested capital thereafter.

A **Carried Interest** (or performance) also applies. This is structured such that FRIFS requires to perform strongly before it benefits under these provisions.

The level of the Management Fee is considered attractive, while the carried interest is considered to be in line with the market for this sector.

2.8 Environmental Social and Governance Issues

The incorporation of ESG principles into FS's investment approach enhances the delivery of commercial returns, while also generating broader long term benefits for the community in which its investee companies operate.

FS points to the positive impact of the significant level of jobs created as a result of its successful growth investments, in addition to its belief that there is a positive correlation between responsible practice and business growth. FS encourages the companies it invests in to strive for best practice in all aspects of their activities, including being responsible businesses.

FS has been a signatory to the UNPRI (UN Principles of Responsible Investment) since 2013.

2.9 Investment Size and Cash Requirements

SPF Fund value at 30th June 2021	£27,501m
DIP allocation (target 5% of main fund) NAV	£ 1,375m
Current DIP NAV	£ 988m
Headroom v NAV	£ 387m

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 30th June 2021 and total DIP commitments to Equity, would be as follows:

Equity, £ in DIP	£208m
Equity, % in DIP	12%
Equity in DIP, as % of Total Fund	0.8%
Equity, % Total Fund (target 52.5%)	61.8%

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.

Climate Impacts:

*Does the proposal support any Climate Plan actions?
Please specify:*

FS has been a signatory to the UNPRI (UN Principles of Responsible Investment) since 2013. 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?

None at this time.

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

None at this time.

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 the Foresight Regional Investment Fund, Scotland by the Direct Investment Portfolio.

Investment Manager – Foresight Regional Investment Fund, Scotland

Foresight Group (FS) is a London headquartered firm which specialises in the Infrastructure (renewable energy in particular) and Private Equity (PE) sectors. Founded in 1984, the group has £7.2bn of assets under management (AUM) across 33 funds, 234 staff (including 115 investment, portfolio management and technical professionals), 12 offices (mainly in the UK but also in Madrid, Rome and Australia) and is listed on the London Stock Exchange.

The FS group now has 200+ international institutional investors, including UK public and private institutions such as the British Business Bank (BBB), the Scottish Government, the European Investment Fund (EIF), Greater London Authority, Blackrock, L&G, Newton and Schrodgers, as well as LGPS investors including Greater Manchester, Clwyd, Nottingham, South Yorkshire, Cambridge, LPFA, Teeside, East Riding, Merseyside and West Midlands.

The FS PE division has been investing in UK SMEs for over 35 years and represents c. £700m of the group's total AUM, with 31 investment professionals with varying backgrounds and collective experience of over 500 PE / corporate finance transactions and managing over 250 investments.

In support of the regional investment strategy, FS has offices in each of the respective regions including Manchester, Nottingham, Cambridge, Milton Keynes, Leicester and now also Edinburgh. A national footprint in the form of a network of local offices, supported by the division's London head office resource is fundamental for its ongoing success.

Summary of Foresight's SME Funds

FS Regional Investment Fund (FRIF)

Fund Size: £58.5m (launched Dec 2015).
Investments: 17 (£1m to £5m) plus 3 bolt-on acquisitions.
Return: Strong.
Exits: 2 exits to date.
Region: Large target region (NW England, South Yorks & North Wales).
Cornerstone: Greater Manchester PF.
 A successor fund (£63.3m) was launched in the same region earlier this year.

FS East of England Fund (FEEF)

Fund Size: £100m (launched July 2019 / evergreen fund).
Investments: 3 (£1m to £5m).
Return: N/A.
Exits: Fund is at a very early stage.
Region: Large target region (70%+ to be deployed in Cambridge, Suffolk, Norfolk &/or Northamptonshire).
Cornerstone: Cambridge County Council PF.

Investment Manager – Foresight Regional Investment Fund, Scotland

FS Nottingham Fund (FNF)**Fund Size:** £39m (launched 2013).**Investments:** 22 (maximum investment restricted to £2m).**Return:** Satisfactory.**Exits:** 4 exits to date.**Region:** Very small target region/market (Nottinghamshire only).**Cornerstone:** Initiated by Nottingham Council via a tender process. BBB is the majority investor (the fund is therefore subject to restrictive State Aid rules). The fund's return has been inhibited to an extent by the small target region, small maximum investment amount and onerous investment restrictions.

FS also manages several other equity funds outwith the regional investment model, including the **Midlands Engine Investment Fund (MEIF)**, funded by BBB and EIF. MEIF operates from offices in Milton Keynes and Leicester with 3 locally based investment managers. The fund has invested £18m across 22 companies (maximum investment £2m) although has non-financial objectives and doesn't therefore have a fully commercial investment mandate.

The **FS Williams Fund** is a joint venture with Williams Advanced Engineering with a current AUM of £67m+. This fund has early stage, deep technology objectives with a higher risk / potential reward mandate which seeks to create valuable intellectual property (IP) assets. This fund invests between £0.5m to £2m and has made 25 investments to date.

FS also manages two **Venture Capital Trusts (VCTs)**. Through its various investment funds/vehicles, FS currently manages over 115 SME portfolio investments in a variety of sectors and stages of development.

Investment Specific Risks

Fundraising

While the fund's strategy and local impact were attractive, DIP's initial discussions with FS identified that in the event that a commitment was made, the challenge would be raising the balance of the funding required.

Since then, FS has developed positive discussions with a number of other Scottish LGPS funds, investment consultants, institutional investors, family offices and its own private clients. While it is hoped that a number of these will lead to investments, it is recognised that DIP requires to take a leading role as the potential cornerstone investor in the fund, without which it may struggle to become established. The proposed investment has been structured to ensure that a modest level of commitments requires to be secured from other investors and FS consider this to be achievable.

Sourcing Opportunities

The fund's strategy is reliant on having a local presence on the ground in the chosen region and this is fundamental for private equity deals at the SME level where deals aren't large enough to attract the attention of remote investors. This was one of DIP's concerns 2 years ago when first considering the FRIFS fund.

Securing the SGF mandate was instrumental in allowing FS to invest in an office and recruit suitably qualified personnel in Scotland. This in turn has led to considerable networking activity by the team in the past 2 years to the extent that FS now has an established profile in Scotland as well as a significant dealflow. This underpins the desktop research undertaken by FS which highlighted the underserved nature of this segment of the Scottish market.

Private Equity Risk

The FRIFS fund is a PE investment vehicle and therefore operates in a higher risk segment of the investment market. The fund will participate in the SME segment of the business sector where the level of experience of management teams will typically not be as sophisticated as found in larger organisations.

Investment write-offs are a feature of such funds, however positive returns are typically generated by successful managers through a majority of investments being at least moderately successful, combined hopefully with 1 or 2 exceptional investments which produce an overall blended positive return.

The main mitigation of this risk is FS's experience and level of success in its existing regional investment funds in England where their track record shows a relatively consistent performance across a significant number of investments.