

Issue #2

Q2 2023

PRIVATE MARKETS PROFILE

Illiquidity Premium
LGPS, private markets and the Edinburgh Reforms

Net Zero Infra
Asset owners on the transition to green infrastructure

Private Equity
Who wins with too much capital chasing too few deals?

Private Markets Forum
Room151 to host LGPS delegates in London, 21 June, 2023

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Introduction

Our second issue of *Private Markets Profile* comes hot on the heels of a government budget that reaffirmed its ambition to steer LGPS assets in the interests of policy objectives.

Not only has the Treasury mooted further consolidation of the eight LGPS pools, but it has also put up for consultation a requirement for LGPS practitioners to consider illiquid assets such as venture and growth capital.

It is of course the job of administering authorities of the scheme to consider all appropriate asset classes – liquid and illiquid - when setting their asset allocation strategies, so they may well argue this work is already underway.

What is clear though, is that appetite for UK infrastructure investing in No.11 is unsated as is their conviction that the LGPS should play its part in building back better (or whatever the current reset is called).

In this issue we've spoken to Gordon Ross (LGPS Central), Jason Fletcher (London CIV) and Ian Sandiford (Border to Coast) about their take on the government's plans and their contributions are both thoughtful and illuminating.

While many have welcomed the consultation there are those who believe that investors within the LGPS must also continue the everyday work of building robust asset allocation strategies that stand the test of time and meet future liabilities.

Needless to say, illiquid assets, private markets, alternatives, whatever we choose to call them are highly likely to play a significant role for most of the administering authorities and all of the pools.

So the work of due diligence and understanding what the various routes to private markets investing are, and which suits your fund's unique characteristics, will continue as always.

To help us explore a raft of different private markets strategies we're delighted to welcome contributions from this issue's sponsors: Bailie Gifford (on private equity); Igneo Infrastructure Partners (on net zero infra); Columbia Threadneedle (on housing investment); and, ICG (on GP-led secondaries).

Each provides a useful and intelligent resource into some of the asset classes and investment opportunities that all LGPS funds must appraise in the interests of their members, above all.

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The LGPS and illiquid assets

Three Local Government Pension Scheme pools tell **Room151** about their investments in illiquid assets, and the impact of the government's Edinburgh Reforms on venture and growth capital in the UK.



Could the Local Government Pension Scheme (LGPS) play a bigger part in boosting the UK economy? The current government certainly thinks so, having called on LGPS funds to invest up to 5% of their assets in infrastructure projects that support local areas – to "unlock £16bn in new investment".

Pressure is likely to increase through the government's "Edinburgh Reforms". In a parliamentary statement on the reforms on 9 December 2022, chancellor Jeremy Hunt promised two consultations this year – one was expected (on asset pooling), but one was not (on investing in illiquid assets).

According to Hunt's statement, the government will "consult on requiring LGPS funds to ensure they are considering investment opportunities in illiquid assets such as venture and growth capital, as part of a diversified investment strategy".

The statement is carefully worded – the use of "considering" and "part of a diversified investment strategy" will allow funds some wriggle room. But the direction of travel is clear, and was reinforced in the March Budget, with the "Red Book" discussing how investments in illiquid assets could "unlock some of the £364bn of LGPS assets into long-term productive assets".

To test the mood, Room151 approached three LGPS pools – Border to Coast Pensions Partnership, London CIV and LGPS Central. We asked about government influence on LGPS investments, the definition of illiquid assets, the current approach of the pools to illiquid assets and the likely future direction.

Is it a good idea for the government to require pools to consider investing in illiquid assets?

Gordon Ross, chief investment officer, LGPS Central
Pension funds and pools should hold a diversified portfolio of investments aligned with their strategic objectives, including an allocation towards longer-term, illiquid assets. Illiquid assets play a crucial role in generating positive financial returns for pension schemes and offer access to opportunities not available in liquid markets.

Illiquid assets provide less volatility in short-term valuations and the ability to influence long-term strategies for the benefit of long-term investors.

Government input may be helpful to those that haven't yet embraced illiquid instruments in their strategic asset allocations. Ultimately, the decision to invest in illiquid assets should be made based on the individual circumstances and the aligned objectives, dictated by strategic asset allocations of a pension fund and its pool.

Jason Fletcher, chief investment officer, London CIV
Is it right for central government to be telling LGPS funds what to do? I'd question that on a number of levels.

We have 97 different local authorities, all of which have a different set of circumstances. Some of them might be 50% in private markets, or illiquids if you want to call them that. Some of them might be 10%. The answer will be very different for each LGPS fund. If both LGPS funds are being told they should invest more in private markets, then that's plain wrong.

I'm fine with guidance, but if it's a requirement from central government to invest more in UK "illiquids", then this is something we have to be a bit careful with.

How would you define illiquid assets – what should be included beyond venture and growth capital?

Gordon Ross
Illiquid assets, such as private credit, equity, infrastructure, timber, agriculture, and property, require capital to be locked up for several years. Venture and growth capital, although relatively small in private markets, require patient capital to help them grow, making experienced buyout operators necessary.

Infrastructure equity investing and private credit are also essential for satisfying a diversity of risk appetites. Property and infrastructure have relatively low price volatility, are long-term investments in established and highly viable assets, and benefit from contracts often linked to levels of inflation making them attractive as inflation hedges. Private credit can offer both lending safety and lending viability if carefully chosen funds are selected.

These assets offer the potential for higher returns over the long term, albeit with some additional risks and hence require a higher level of due diligence expertise and management.

Jason Fletcher
I see the word "illiquid" as a factor rather than an asset class. My definition would be "private markets".



"Ultimately, the decision to invest in illiquid assets should be made based on the individual circumstances and the aligned objectives, dictated by strategic asset allocations of a pension fund and its pool."
Gordon Ross, LGPS Central



Venture capital tends to focus on small start-up investments, expensive, high expected return and high risk. Growth capital is really private equity or investments in private markets, not quite so expensive and with lower expected returns and risk.

London CIV invests in infrastructure, renewables, property, property leases, UK housing and private debt for our clients. I don't know whether you can define any of those as growth, but who's to say what growth is – it's another factor if you like.

Ian Sandiford, head of private markets, Border to Coast Pensions Partnership
Within a general definition, we would include private equity (including buy out and special situations) and, in addition to the venture and growth capital referenced above, infrastructure and broader real assets, private credit, private real estate and hedge funds (noting that hedge funds do not form part of our current investment strategies).

How much has your pool invested in venture and growth capital (and illiquid assets more generally)?

Gordon Ross
The LGPS Central pool has committed to its first and second private equity primary partnerships. The 2018 vintage is committing £150m to upper mid-market and larger funds, while the 2021 vintage has £365m of capital and focuses on growth and small buyouts, committing at least £100m to UK technology and technology-enabled companies. In total, LGPS Central has raised over £4.2bn across three private market asset classes for its partner funds.

Jason Fletcher
We have a number of investments that cover venture and growth capital, but we don't define them that way.

Ian Sandiford
Our partner funds had committed £9.7bn to our private markets programme by the end of December 2022, of which £8bn has been committed to underlying funds and co-investments. Within this, £2.4bn has been raised for our private equity programme, with around £600m committed to venture capital and growth strategies.

Are there any examples of successful investments your pool has made in venture and growth capital?

Gordon Ross
LGPS Central's private equity portfolio includes successful investments in IVC Evidensia and Advent Life Sciences Fund I and II. The latter's investment, a UK venture prospect, used capital to create a new company that subsequently spun out a new entity, which has developed a first-in-class therapy for the treatment of menopausal symptoms.

The investment is currently valued at 18.4x Multiple on Invested Capital (MOIC) with a 62% Internal Rate of Return (IRR).

Jason Fletcher
We have launched five different funds in private markets, which we would define as illiquids: two infrastructure funds, one of which is focused on renewables; a private debt fund; the London Fund (which invests in infrastructure, property and private capital); and a real estate long income fund with £2.3bn of client commitments.

"Following the LDI crisis in September, many private pension funds were forced sellers. This means that many private market opportunities are becoming available in the secondary market."
Jason Fletcher, London CIV

We're also about to launch a UK housing fund that will focus on affordable housing and already has support from Lambeth Pension Fund.

Ian Sandiford
We launched our private markets programme in 2019, although most commitments have been made from 2020 onwards. To date we have launched private equity, infrastructure and private credit strategies, with a multi-asset Climate Opportunities strategy launched in 2022.

Given the relative immaturity of the programme, it is still too early to be considering successful exits from the venture capital and growth commitments.

Nonetheless, the programme is already providing exposure to a range of investment opportunities less easily accessed through public markets. These include innovative, fast-growing businesses focused on software, communications, next generation networks, fintech, life sciences and late-stage development pharmaceuticals, accessed via a range of specialist funds and managers.

What percentage of your investments are in illiquid assets and are you planning to increase this?

Gordon Ross
The trend of investing in private markets has been growing in importance for pension funds and is expected to continue. The LGPS Central pool has not set any targets for investments in illiquid assets, but our underlying partner funds are increasing their allocations to private markets, as part of their strategic asset allocation, as it remains a growth area for investment.

One of our pension funds plans to take a recommendation to its pension committee proposing its first-ever allocation to private equity in March, as part of its strategy to increase its exposure to illiquid assets.

Jason Fletcher
Ten percent of London CIV's pooled assets are in private markets and we/our clients will likely be investing more in private markets going forward.

Following the LDI crisis in September, many private pension funds were forced sellers. This means that many private market opportunities are becoming available in the secondary market.

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Ian Sandiford
Ultimately this is a decision of our partner funds, but they have around £60bn of assets, and have (to date) committed around £10bn to private market strategies offered by Border to Coast and also have legacy private market portfolios.

A number of our partner funds had well established private market programmes prior to pooling, but for others pooling has presented an opportunity to invest into these more complex asset classes for the first time. While each partner fund's position is different, at present the direction of travel appears to be an increasing exposure to private market investment as a percentage of overall assets.

Are illiquid assets a useful hedge against inflation?

Gordon Ross
While not perfect, investing in infrastructure projects can be a useful hedge against inflation, as many projects have prices linked to the Consumer Price Index (CPI) and have inflation-linked uplifts. The direct lending sector has started offering inflation-linked products, such as inflation-linked investment grade UK infrastructure debt. Infrastructure investment provides a useful hedge against inflation as contracts have inflation-linked uplifts. As a result, it is becoming increasingly popular for this purpose.

Jason Fletcher
It's not to do whether investments are public or private, it's about the underlying investments you make. So if you are investing in a power station that gets paid CPI+ for the energy it produces, then that gives you some inflation protection. If you invest in a property that has a CPI uplift to the rent, then it gives you some inflation protection.

The fact that power stations/property are illiquid, or liquid, makes no odds whatsoever.

Matching inflation right now is very challenging. If you have a target of inflation plus 2%, that's a 12% return. Best of luck with that. But if you'd said a target of inflation plus 2% over the next 10 years, yes, we can find some investments to do that. And when you look in the long run, historically the best match for inflation has been listed liquid equities.

"Matching inflation right now is very challenging. If you have a target of inflation plus 2%, that's a 12% return. Best of luck with that."
Jason Fletcher, London CIV



Ian Sandiford
It is largely asset-dependent. Illiquidity in and of itself is not a hedge against inflation.

Infrastructure can offer inflation-linked revenue models, as experienced with some operational infrastructure assets including (but not limited to) some renewable energy assets, which can provide a degree of protection against inflation, or a positive correlation with inflation, but this is unlikely to be a perfect hedge and is asset specific.

Contractual arrangements for any asset need to be assessed to determine the degree of inflation linkage and whether this flows through to earnings or is absorbed by inflation-linked input costs. It will also depend on the level and nature of leverage arrangements on any asset.



Private debt is typically structured as "floating rate", which can provide a hedge against inflation, while private real estate could also be structured with inflation-linked, upward-only rent reviews.

What are the dangers in investing too heavily in illiquid assets?

Gordon Ross
It is important to avoid over-committing to illiquid asset classes as the committed capital may not be immediately required for investment, and investors must ensure that they can fund any commitments made to illiquid assets. Typically, committed capital for illiquid asset classes can take up to five years to be drawn down, and it is crucial to have the ability to meet these drawdowns without resorting to fire-sales (usually from liquid asset allocations held by the fund). Failure to meet funding obligations can result in being declared a defaulting investor.

"It is essential to understand that not all illiquid assets have the same characteristics, often reflecting a spectrum of liquidity."
Gordon Ross, LGPS Central



Distributions from illiquid asset classes are also uncertain and should not be relied upon for cash flows to fund outstanding or new commitments. It is essential to understand that not all illiquid assets have the same characteristics, often reflecting a spectrum of liquidity. The cost of investing should also be considered, as it has the potential to negate the liquidity premium associated with these assets.

Jason Fletcher
The LDI [liability-driven investing] crisis in September is a perfect example.

A sufficient level of liquidity is required by pension funds. And that's not necessarily cash. It's near assets. It could be equities. It could be bonds, it could be all kinds of things, but you need to have sufficient liquidity to cover you in bad times.

You need to think medium term on this. You can't sit there with 20% in liquid assets, sell 10% to meet next year, and then 10% the following year, and then suddenly be left with 100% in private markets that you can't sell when you need to.

And anyone who suggests borrowing money to get around that problem, just say no, it's usually a bad idea.

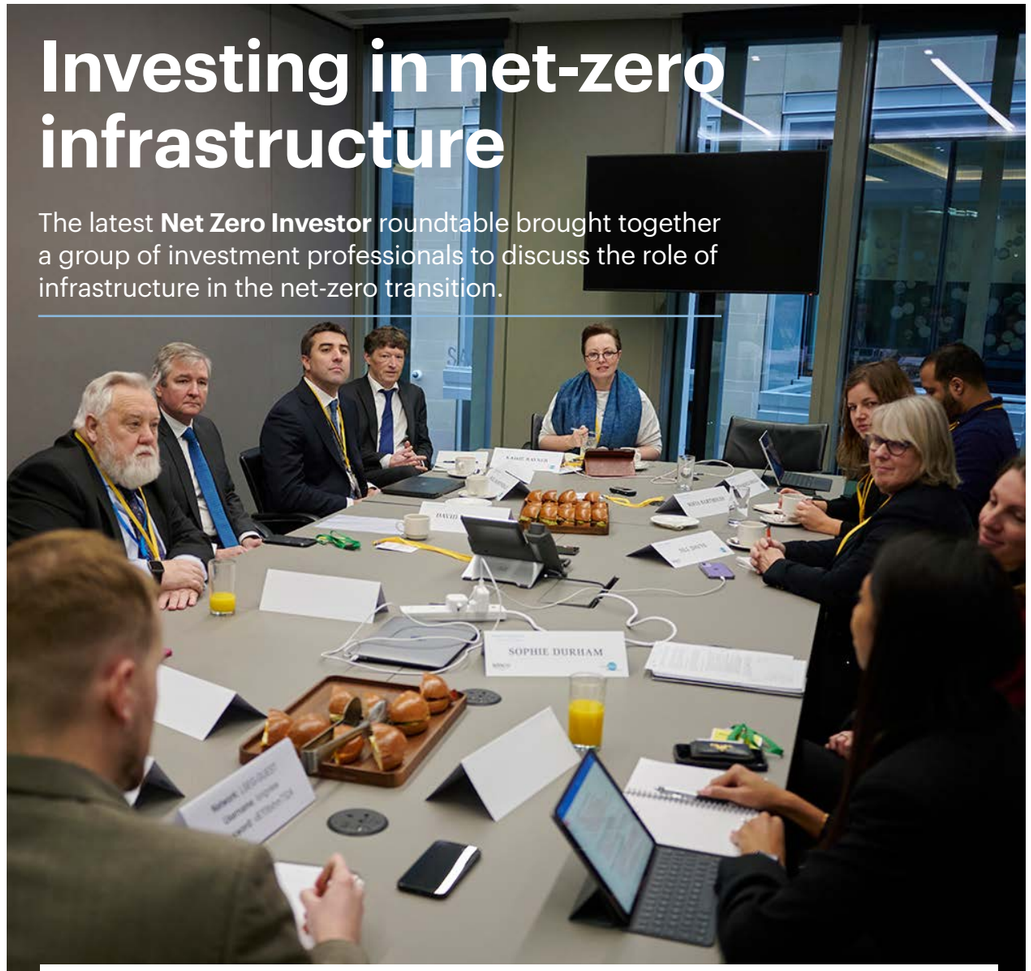
Ian Sandiford
The degree of "danger" will depend on an investor's liquidity requirements. You have to be committed for longer periods and, by definition, investors do not have the ability to easily access cash locked up in an asset, and any liquidity may be at a meaningful discount to carrying value.

Equally, it is generally a more complicated asset class to navigate given the nature of the sectors and other considerations such as legal structures. So the more heavily invested you are, the more resource you might need to commit to the ongoing management of the investments.

■ ***Gordon Ross is chairing Room151's LGPS North conference on 27 April in Leeds. Ian Sandiford will be speaking at the conference on the session covering investing in illiquid assets.***

Investing in net-zero infrastructure

The latest **Net Zero Investor** roundtable brought together a group of investment professionals to discuss the role of infrastructure in the net-zero transition.



ATTENDEES

Sofia Bartholdy, *net-zero lead – responsible investment,* **Church Commissioners for England**
Graham Cook, *CIO,* **Environment Agency Pension Fund**
Jill Davys, *head of LGPS,* **Redington**
Matt Deane, *business development associate,* **First Sentier**
Sophie Durham, *managing director, head of ESG,* **Igneo Infrastructure Partners**
George Kendall, *responsible investment manager,* **Border to Coast**
Mohammed Khalil, *ESG equity strategist,* **Phoenix Group**
Chris Marchant, *senior reporter,* **Net Zero Investor**
Will Martindale, *co-head of sustainability,* **NOW: Pensions**
Devina Parasuraman, *director for infrastructure investments,* **Igneo Infrastructure Partners**
Kaisie Rayner (chair), *founder and director,* **A future worth living in**
David Russell, *head of responsible investment,* **USS**
Paul Watchman, *special advisor to the UN on climate change and ESG*

In the "decade for delivery" a tsunami of private capital will be unleashed on infrastructure to help deliver net zero. Not all of it will be wisely invested and risks abound as competing capital jostles for the best opportunities.

Net Zero Investor convened a roundtable to explore the burgeoning appetite for infrastructure investments that will underpin the net-zero transition, the ideas driving innovation and the pitfalls for private markets' investors facing stiff competition and issues of scale.

The infrastructure debate was part of a wider net-zero discussion that also covered the role of asset owners, fund selection and manager research. The infrastructure section began with Sophie Durham from the sponsor of the event, Igneo infrastructure Partners, explaining the role that infrastructure can play in the journey to net zero.

Sophie Durham
Igneo manages about €16bn of assets globally, mainly in the power, utilities and transport sectors. Some of our businesses operate in sectors traditionally thought of as hard-to-decarbonise, but they're also essential to the economy and provide essential services.

Infrastructure is an asset class that is going to deliver a lot of solutions to net zero.

So we're doing two things: we're investing in climate solutions and working with more carbon-intensive companies to help them transition.

We have invested over 1.8 billion Euros in the last three years in pure play renewable energy businesses. We own the third largest wind power producer in Portugal, the greenest district heating provider in France, and the largest renewable energy producer in Estonia.

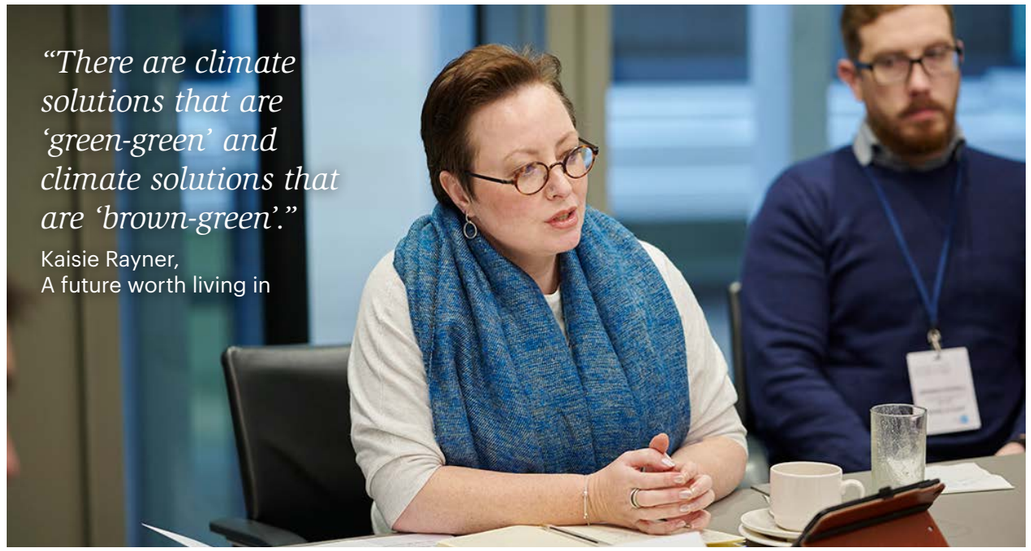
We could, of course, buy more and have a nice green portfolio, but that isn't our investment mandate, and it also doesn't address the challenge of businesses in other sectors, such as district heating, that may be more carbon-intensive today but are also crucial to the energy transition.

Igneo owns MVV, a German integrated regional utility business. Today, MVV has some coal- and gas-fired power generation in its portfolio. We invested in the company two years ago and it originally planned to phase out coal, in line with the German government's policy, by the mid-2030s and reach net zero by 2050.

"We found opportunities not only to generate value for our investors, but also to have a significant positive environmental impact – taking millions of tonnes of CO2/year out of the air ten years earlier than was going to be the case before we fully invested."

Sophie Durham, Igneo Infrastructure Partners





We worked with our co-shareholder, the city of Mannheim, to make that plan more aggressive. So MVV is now phasing out coal by 2030, maybe even earlier. And they’re going to reach net zero by 2040. The targets have been verified by the Science Based Targets initiative (SBTi) – the first German energy company to get that stamp of approval.

MVV is an example of a business where many people might not have made that investment because it’s carbon-intensive at the moment. But through working with the company and our co-shareholder we found opportunities not only to generate value for our investors, but also to have a significant positive environmental impact – taking millions of tonnes of CO2/year out of the air ten years earlier than was going to be the case before we fully invested.

Kaisie Rayner
What I’m hearing is that there are climate solutions that are “green-green” and climate solutions that are “brown-green”.

“It’s not just about the ‘clean’ stuff. It’s about transitioning the other stuff, and I think that’s really important.”
David Russell, USS

David Russell
We have £1.9bn already invested in renewables and renewable energy tech, and have been invested in this sector since 2001. We have another half a billion allocated and that’s all in our private markets.

It’s not just about the “clean” stuff. It’s about transitioning the other stuff, and I think that’s really important. One of the challenges is people coming to us selling green stuff. We’d love to buy it, but usually it’s too expensive. And



when we invest a lot in direct infrastructure, we are outbid quite frequently by deep-pocketed oil and gas companies.

It’s how you transition everything that I think we’ve got to focus on, not just the fact we have to allocate to renewable energy, clean tech or the assets of the future which are really difficult to invest in if you are a really big pension fund. And VC funds are tiny. So yes, how you transition everything is the issue.

Kaisie Rayner
So it used to be about exclusions, and then it was about the super green stuff. The stuff in the middle is harder. So do you think we’re getting to a place now where we’re having to tackle this bit in the middle, which is neither “black dirty” nor “super green“? Do you think that’s where the shift in focus is going to be over the next five years, as the low-hanging fruit on either end has started to be grabbed?

Devina Parasuraman
I think the challenge we’re dealing with to address the energy transition is that the green is very easy. There are lots of funds out there seeking those opportunities. The grey and the really dirty, no one wants to touch that. The middle is where the most amount of work needs to be done.

At Igneo, we are infrastructure investors seeking high-quality assets where we can engage with those companies to help them on their transition journey. So for us, we find these opportunities very exciting.

We recently acquired an energy from waste company in the UK, one of the largest ones. The company’s operations save the UK almost 600,000 tonnes of CO2/year compared to the alternative of landfill. However, it is still one of the highest direct emitters in our portfolio. We’re working there on carbon capture solutions. These are not technologies that are feasible today, but we’re working on the solution now. And it’s always those types of opportunities we’re looking at where we can add value and make those businesses long-term sustainable enterprises.

Jill Davys
I want to address the point about why people aren’t putting lots of money into illiquid assets. If you’re not a defined benefit pension scheme, in most instances, you’re closed to future accrual. And you’re actually looking to get out to buy out within the next five to ten years. So do they care what happens after ten years? Probably not. It is about funds like the USS and the LGPS where the longer-term horizons really do make a difference.





We are going to be paying out pensions more than 80 years into the future. This really does impact on our beneficiaries. I think the other issue with illiquid assets, particularly in the DC space, is around the costs. You cannot access these assets particularly cheaply. And you still have caps in terms of how much you're allowed to pay in fees. So how do we negotiate with the fund managers to get those fees down?

George Kendall
We have around £2bn committed capital from our partner funds for our Climate Opportunities fund, which is essentially a mix of infrastructure assets, private equity and private debt. It's geared towards looking at opportunities, not just at the green end, but those businesses that are ripe for transition as well.

"One of the challenges with emissions-intensity disclosures in isolation, is that they may be ranked. In other words, portfolio A has higher emissions-intensity than portfolio B. This can lead to perverse incentives."

Will Martindale, NOW: Pensions

Graham Cook
For us, infrastructure sits within our net-zero action plan as an enabler of the transition. And that's distribution and grid scale storage and all those things that need to be in place for us to move to a post-transition world. Two of the most important aspects that do not get enough attention when looking at infrastructure are natural capital, and physical risk and adaptation.



Will Martindale
One of the challenges with emissions-intensity disclosures in isolation, is that they may be ranked. In other words, portfolio A has higher emissions-intensity than portfolio B.

This can lead to perverse incentives. For example, it may incentivise an investor away from investing in emerging markets, as emerging markets tend to have higher GHG emissions, even though it is emerging markets that require the capital to transition.

As such, the emissions intensity of a portfolio requires context, such as the jurisdictions represented or the type of assets.

The fees issue is also very real. For example, impact investments tend to be higher fee. As is illiquidity, particularly in the consequences of the LDI crisis. Another issue is currency risk if we're looking for overseas transition opportunities.

Addressing these issues seems to me like a relatively light policy fix.

David Russell
On the illiquid assets point, we're very lucky in that we have been able to fold our in-house infra into our DC offering (because we are a hybrid scheme). But the mark to market issue is one that really needs to be sorted out and that is a regulator issue.

And the fee cap means that basically it's not going to be possible because most funds charge more than 70 basis points. There needs to be a way round that.

Final point, we can't divest our way to net zero – we have to transition. We can't just invest in the clean tech, even if it is infrastructure or other assets. It's all about how we transition.

Paul Watchman
Leadership is really important from both the corporate side and the investment side. I truly believe in renewable energy local enterprise zones.



"Leadership is really important from both the corporate side and the investment side."

Paul Watchman, special advisor to the UN on climate change and ESG

Chris Marchant
Can portfolios truly have science-based targets with the current quality of ESG data?

Will Martindale
Science-based targets is a really important intervention. It allows investors to understand a company's decarbonisation objectives, per sector and geography, consistent with prevailing understanding of the science.

However, this is because each sector is dependent on other sectors to create a decarbonisation budget. As such, their interpretation requires constant monitoring and care.

Graham Cook
You can have targets based on the science; they don't have to be science-based targets.

Devina Parasuraman
In terms of the net-zero infrastructure outlook, I think the current energy crisis has highlighted concerns around security of supply and



"It's expected that we'll need around $4trn in investment in this decade to achieve net-zero infrastructure."

Devina Parasuraman, Igneo Infrastructure Partners

affordability of energy sources. And what that has meant is in terms of the speed of the energy transition, we might be going backwards in the immediate term, when some countries are talking about reopening coal mines and restarting coal plants.

But I think in the medium to long term, it's expected to speed up the energy transition for two key reasons. One is the concerns around security of supply. That has meant there is an increasing focus on energy independence, on decarbonisation, and also affordability of energy sources. And, two, is those low-carbon solutions, such as green hydrogen CCS, are becoming more cost-competitive.



And also on the investment side, we haven't seen a slowdown in commitment to developing more renewables, more low-carbon solutions. And just a quick fact: it's expected that we'll need around $4trn in investment in this decade to achieve net-zero infrastructure.

Sophie Durham
My closing comment would be to say that we need faster progress. The financial industry, for asset owners and managers, has been good at setting targets and getting better at reporting. Where we need more progress is in translating those targets into action.

Jill Davys
If we've got any hope of achieving net zero by 2050, we need to see action on the part of policymakers, government, asset owners, companies, you name it, we've all got to do our bit. We can only do so much as asset owners.

"Sometimes a coherent and impactful net-zero strategy is not the same as a good-looking strategy."

Sofia Bartholdy, Church Commissioners for England



"It will be a lot easier if stakeholders and counterparts are working towards the same goal as you."

Mohammed Khalil, Phoenix Group

Sofia Bartholdy
The first thing is to identify what needs to happen in the world and understand what your role is and where your unique levers are. And focusing where you can have impact and collaborating. And then sometimes a coherent and impactful net-zero strategy is not the same as a good-looking strategy. That's another challenge for the industry.

Mohammed Khalil
Depending on what organisation you're a part of, your investment agenda, your stewardship engagement agenda, how you deal with your own affairs, do have to be aligned if you're going to make this net-zero transition. I don't want to say it won't be painful, but hopefully smoother, so that it may not necessarily be the best looking. But at least it will be a lot easier if stakeholders and counterparts are working towards the same goal as you.

George Kendall
The commitment is there from the financial sector, the commitment is there from LGPS funds. Opportunity is there for policy to follow, but when we look at the outcomes of the COP27 conference, it doesn't seem like everyone is singing from the same hymn sheet and that's got to change.



"When we look at the outcomes of the COP27 conference, it doesn't seem like everyone is singing from the same hymn sheet and that's got to change."

George Kendall, Border to Coast



The potential of private equity

Baillie Gifford's **Tom Wright** discusses why more value is being captured by private equity and how the Local Government Pension Scheme can benefit from this.

A profound shift has occurred in capital markets. Private equity investors such as the Local Government Pension Scheme (LGPS) may have to evolve their approach if they are to have enough exposure to the fastest-growing, most disruptive, and impactful companies around.

What is this shift? Companies are staying private for longer. Amazon and Google IPO'd after three and six years respectively, but the average age of a company at initial public offering (IPO) has doubled to 11 years, with Baillie Gifford holdings such as SpaceX still private after 20 years, and Epic Games holding out after 32 years.

More regulation and the increased availability of capital in private markets, as well as public market turmoil, are part of the reason for this, meaning fewer entrepreneurs see going public as the coming-of-age moment it once was.

The opportunity is huge. By January 2023, 2,205 private companies were valued at over $500m each, with an aggregate value of $5.2trn — more than double the size of the listed US midcap market, and almost twice that of the FT All Share.

These include many unique companies such as SpaceX, TikTok owner ByteDance, and payments giant Stripe – all owned in Baillie Gifford's specialist private funds – which remain unlisted despite being valued in the tens or hundreds of billions of dollars.

Positive impact

They also number businesses that are addressing society's biggest challenges. Regarding ESG, primary LGPS capital can have a direct, positive impact by enabling companies such as green battery manufacturer and recycler Northvolt, synthetic biology business Solugen, and direct carbon capture leader Climeworks to achieve their goals while also making superior returns.

There is a lot of capital chasing deals and no shortage of investors who can write large cheques at premium valuations.

In contrast to public markets, private companies get to handpick their shareholders. So what makes an investor the partner of choice, able to access the most interesting funding rounds at attractive valuations? And how can LGPS allocators identify which managers will be able to do this?

First and foremost, it's not just about money. There is a lot of capital chasing deals and no shortage of investors who can (and in 2020-21, frequently did) write large cheques at premium valuations.

More important to founders is an investor who can focus on the company's long-term development, up to IPO of course, but far beyond that.

COMPANIES ARE STAYING PRIVATE FOR LONGER

Structural reasons

- Technology-enabled, capital-light business models enable founders to retain control for longer
- Regulation makes it easier to stay private (JOBS Act) and more burdensome to be public (Sarbanes-Oxley)
- Availability of capital in later-stages of private markets

Cultural reasons

- IPO no longer seen by founders as defining moment of success
- Founders increasingly realising they can build better businesses by staying private longer
- Less distraction from public markets means greater focus on execution
- Lower risk of misaligned shareholder base

Time to IPO and market capitalisation at IPO illustrative examples:

Amazon founded in 1994
1997 listed at $0.4bn

Google founded in 1998
2004 listed at $23bn

Facebook founded in 2004
2012 listed at $104bn

Spotify founded in 2006
2018 listed at $27bn

SpaceX founded in 2002
2023 last funding round at $137bn[1]

ByteDance founded in 2012
2022 last funding round at $240bn[2]

[1]SpaceX valuation as at 3 January 2023. [2]ByteDance valuation as at 28 November 2022. US$.

Portfolio companies which Baillie Gifford first bought when private take an average of 9 years to come to IPO

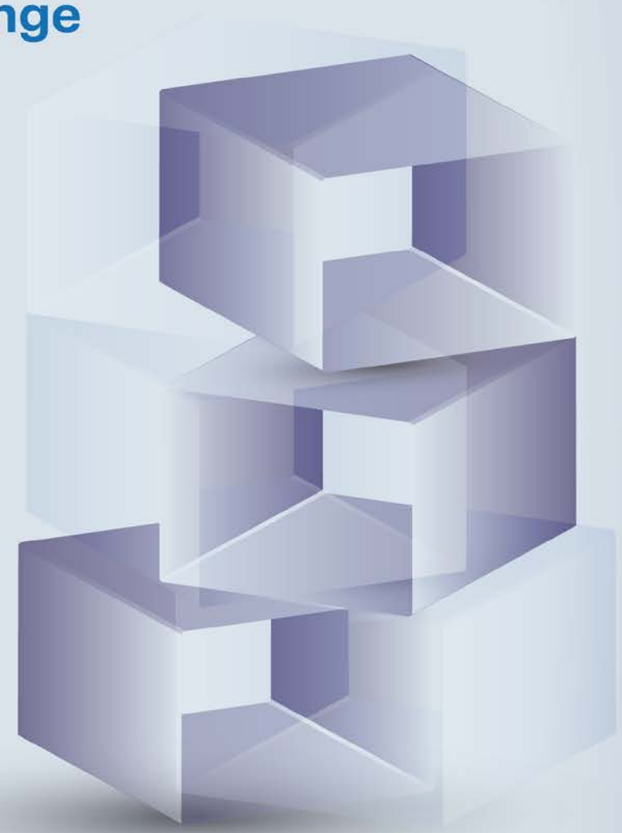
As at 31 December 2022

A date for your diary...

Room151's LGPS Investment Forum

8th November 2023
London Stock Exchange

Find out more



Lead sponsor
octopus investments
A brighter way

This is where there is a mismatch with existing VC structures. These have limited seven- to 10-year lives and become forced sellers just as growth may be accelerating. This does not align with the needs of many founders, who are often mission-driven, focusing on multi-decade transformations and not short-term valuations.

At this later stage, founders seek trusted partners from within the VC ecosystem of founders, industry leaders, and earlier-stage investors. These investors embrace risk, support innovation, and invest over multiple funding rounds, laying the foundations for future success.

Founders also value a patient voice that encourages other shareholders to think likewise. A longer-term time horizon enables founders to go through multiple funding rounds with no pressure to IPO before they are ready, just because it may suit the liquidity needs of shorter-term investors. Companies can pursue their strategic objectives rather than obsessing over the risk of the inevitable shorter-term missteps.

Private to public

Having a reputation for long-term and patient support of risk-taking innovators helps generate access to a broad spectrum of the most promising deals globally. Baillie Gifford has earned this reputation, having been early backers of Spotify, Alibaba and Affirm, all of which we first owned privately, and continue to hold in size in public portfolios.

This ability to continue to hold and even add capital from other strategies at and post-IPO is particularly attractive because founders do not want a wholesale change of their shareholder base at IPO, as early backers cash out and are replaced by a host of new owners, many with differing motivations and investment horizons.

Having experience with public markets may also be important as founders seek to position their companies for life beyond the private markets. This may involve discussing governance practices such as those expected by LGPS members, and how to retain a culture that will maximise the probability of success after listing. This is a serious "value add" that traditional private equity investors and deal-focused investment banks are less able to deliver.

The LGPS has always provided long-term capital to exceptional businesses, allowing members' assets to compound in value over time and deliver sustainable, affordable pensions. But a different approach that understands the changing needs of these businesses is now required.

Understanding this, and identifying managers who can access these opportunities, will enable the LGPS to fully participate in the outstanding returns that these most exciting, innovative, disruptive and impactful companies have the potential to deliver.



Tom Wright is a director in Baillie Gifford's Private Companies Investor Relations team.

Build to rent investment – performance, resilience, and a great diversifier

Columbia Threadneedle's **Guy Glover** and **Emma Gullifer** examine why 'the world's largest asset class' has found a home in the pension fund investing mainstream.



The total value of the world's stock markets is c. USD 95 trillion (Apollo Global Management) – a figure dwarfed by the estimated size of the world's residential real estate value at USD 258 trillion (Savills).

Given this context it is no surprise that institutional investors, and particularly pension funds, are increasingly allocating significant sums to the world's largest asset class as a stand-alone component of their portfolio. Residential property is no longer an emerging asset class or viewed solely as an ancillary part of a commercial property allocation. Why is this shift occurring and how does residential investment deliver for a pension fund?

Performance & Diversification

Over the long-term residential real estate delivered 11.1% (per annum) on average, that is c.46% greater than equities, bonds, or even commercial property which each average between 7.3% – 7.6% over the period between 1990 – 2021. Residential also offers a resilient return which can outperform across market cycles and periods of market volatility; take the average of any rolling 5-year period since 1990 and residential real estate regularly outperforms against bonds and equities. Though please remember that past performance does not predict future returns.

It also acts as a true diversifier with limited correlation to either equities or gilts, with correlations at 0.27% and -0.05% respectively. To cap off residential's credentials from a portfolio perspective, it is also less volatile as detailed in the table below. Better performance, enhanced diversification, and reduced volatility – a pension fund's dream.

Higher income with inflation aligned income growth

Residential real estate can also provide long-term income growth aligned to inflation, while typically delivering a significantly higher net income than government backed inflation linked gilts. While residential market rents are not typically directly linked to inflation, the correlation is understandable due to the obvious link to wage growth which determines an individual's ability to pay and provides a remarkable alignment to inflation (98% correlation).

The long-term rental growth evidenced in the sector is very resilient, going some way towards neutralising market cycle volatility from an investor's viewpoint. While a buoyant economy can always support growth across all types of assets, the residential sector benefits from a degree of downside risk protection. In more challenging economic times, individuals are less likely to seek to make a major housing purchase, which can boost rental demand and hence rents in what is a dramatically



undersupplied sector. Higher income, inflation aligned growth and income resilience – again, a pension fund's dream.

The fundamentals – supply and demand

The fundamentals of the sector are compelling. On the demand side, increased household formation, higher immigration and urbanisation, reduced household average size, and positive population growth are all driving the rise in the number of rental households. On the supply side, a long-term undersupply of new housing across the UK and an ongoing net reduction in buy-to-let stock is putting increasing pressure on the availability of accommodation and unlikely to be resolved any time soon.

On average, every year the UK delivers 100,000 fewer homes than is required and due to limited construction starts, a complex planning system and cost of building combined with a restricted supply of labour, this number is unlikely to improve for the foreseeable future. This has coincided with a significant shift in current supply with the traditional provider of stock – the small buy-to-let investor – regressing from the market. This is the case for multiple reasons, but mainly tax changes, and they have been net sellers of stock at a significant rate of 76,000 units in 2022 and 300,000 over the past 5 years. The fundamental imbalance of demand and supply has never been as compelling, and importantly for the future performance outlook, many of these drivers are structural and likely to play out over the long-term.

Delivering on the ESG agenda

Delivering on the ESG agenda is where build-to-rent investing can really move the dial. The sector not only offers the opportunity to enhance supply of much needed homes and address quality concerns in the private rental sector by providing professionally managed purpose-built accommodation; investment can also target affordability to provide houses for the mass market in areas

CORRELATION

	Residential	All Property	Equities	Gilts
Residential	1			
All Property	0.75	1		
Equities	0.27	0.42	1	
Gilts	-0.05	-0.08	0.09	1
Average, %y/y	11.1	7.3	7.6	7.5
Standard deviation	8.4	9.2	15	9.4

Source: Real Estate Strategies

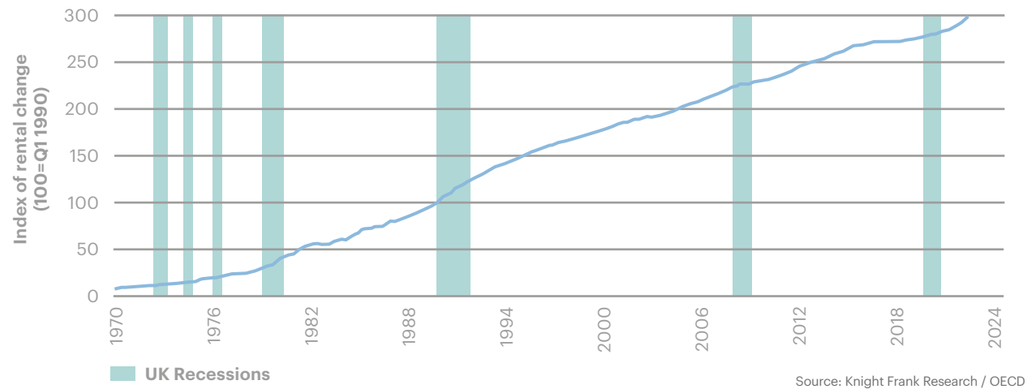
historically overlooked. This offers a broad spectrum of the population access to quality rental accommodation on longer term leases, enabling them to settle into the neighbourhood and integrate, create homes for their families and build lives.

The social benefits of providing additional rental accommodation to a community cannot be underestimated. New buildings are 60% more energy efficient on average, not only delivering cost savings for occupiers, but also reducing the impact homes have on energy consumption. Institutional and informed capital investing into the sector provides greater impetus for the creation of operationally net zero homes and provision of biodiversity net gain across new schemes. The ability for a real estate asset manager to specify and undertake direct interventions to deliver on the environmental agenda can go so much further than indirect engagement can typically deliver. It can benefit people and the planet.

Mainstream asset class

So why should pension funds be increasing allocations to residential real estate, and why now? Residential can deliver long term outperformance compared to other traditional asset classes, proper diversification benefits, lower volatility, high income, and inflation alignment, and is well placed to deliver growth over the long-term. The opportunity lies in a rapidly expanding institutional-grade market backed by compelling imbalance between supply and demand fundamentals, and additionally it can deliver on the ESG agenda which is increasingly a focus for trustees, members, pensioners, and pension fund managers.

PROVEN LONG-TERM COUNTER-CYCLICAL RENTAL PERFORMANCE



Source: Knight Frank Research / OECD



GP led-secondaries: the basics and the benefits

Ricardo Lombardi, global head of ICG Strategic Equity, sets out the current market conditions and future potential for GP-led secondaries and makes the 'win-win' case for both GPs and LPs.

What are GP-led secondaries?

A GP-led transaction is one where a private equity manager (or "GP") sells an asset(s) from its existing fund to a newly created "continuation vehicle" that the GP continues to manage. A secondaries fund typically provides the capital for the transaction and sets the price at which the sale takes place. Limited partners (LP) in the selling fund are given the option to receive liquidity for their interest in the asset(s) at the price set by the GP-led transaction, or reinvest into the continuation vehicle as an LP alongside the secondary buyer and retain go-forward exposure.

What are the benefits?

GP-led transactions are a creative solution that solve multiple objectives for GPs, whilst at the same time offering a liquidity option for LPs.

GPs can retain core assets that they believe will provide attractive returns in the future and allow portfolio companies to continue a value creation trajectory through continued organic growth, M&A or other strategic initiatives that require more time and/or capital. GPs also have an opportunity to increase their personal investment and realign their economic incentives to their highest conviction assets where they see further upside.

LPs are given the option to receive liquidity at a valuation tested by a third party in a transparent process, or roll their interest into the continuation vehicle. It is a win-win for both parties as it is a neat solution to the constraints that typical PE fund structures impose on both LPs and GPs.

What is the attraction for investors?

GP-led transactions can deliver buyout-like returns to investors but with significantly lower risk, thus offering some of the most compelling risk-adjusted returns within the broader alternatives asset class.

Investors in GP-leds benefit from the positive selection bias inherent in these transactions, as GPs proactively cherry-pick their highest conviction assets within their own portfolio, resulting in a filtered opportunity set that is naturally of higher quality than one would expect in the buyout market, thereby mitigating any potential concentration risk.

These assets are typically outstanding performers that have already been successful and have a clear and compelling path to continued value creation, which is the reason the GP does not want to sell to a third party. By renewing the investment time horizon, GPs and management teams can continue executing against the existing value creation plan, which is already working. GP-led transactions typically also provide incremental unfunded capital for companies to further accelerate growth through M&A, which typically was not available to them under the prior fund structure.

By partnering with the incumbent GP and management team who have owned and managed the asset for several years, secondaries investors are effectively "buying with the insiders". As a result, there is limited information asymmetry for secondaries investors, who receive a transparent view on the true state of the business and its prospects, which reduces the risk of negative surprises after the investment.

The GP is also highly aligned with the secondaries investor since the GP typically re-invests a material amount of any carried interest crystallised from the sale of the

asset into the newly formed continuation vehicle, resulting in a significantly larger GP commitment than a typical buyout fund.

Lastly, because a GP-led does not trigger a change of control in the debt docs, the new fund can effectively inherit the existing capital structure. As these companies tend to be strong performers, they have usually grown considerably since the time of the GP's initial buyout of a few years earlier when the capital structure was put in place. As a result, these transactions typically have significantly less leverage than one would expect in a typical buyout transaction.

How do you expect the current market environment to impact the GP-led market?

Historically, sponsors have typically exited assets by selling them to other private equity funds or through IPOs, but recent market volatility and a tough financing environment have constrained these traditional exit routes. As a result, liquidity for LPs has dried up. Declines in public market valuations have also resulted in many institutions being overallocated to PE. These dynamics make GP-led transactions an even more compelling option in the current environment because they allow sponsors to generate liquidity for LPs whilst avoiding an outright sale in a depressed M&A environment.

What is the long-term outlook for the GP-led market?

GP-led market volumes have grown from $11bn in 2016 to $48bn in 2022, and now represent more than half of overall secondaries volumes. As a widely accepted tool used by LPs and GPs to manage liquidity in the PE asset class, the market is expected to continue its strong growth trajectory, supported by long-term, secular tailwinds.

"GP-led transactions are an even more compelling option in the current environment because they allow sponsors to generate liquidity for LPs whilst avoiding an outright sale in a depressed M&A environment."

Ricardo Lombardi, ICG Strategic Equity

The penetration of GP-led transactions remains very low today. For example, of all PE exits by value in 2022, less than 5% were through continuation vehicles. Penetration should continue to increase as most established PE sponsors now understand the benefits of a GP-led transaction as a portfolio and liquidity management tool. Furthermore, PE AUM, which represents the total pool of potential assets that could be involved in a GP-led transaction, grew approximately 3x between 2016 and 2022, from $2.6tn to $7.6tn. The combination of growing penetration and an expanding addressable market suggests there is a long runway for continued growth over the long-term.

Notwithstanding, the biggest constraint for volume growth today is buyer capital, not the supply of deal flow. The opportunity set evaluated by buyers is far higher than the volume of deals closed. This demand-supply imbalance creates an attractive market dynamic, whereby secondaries investors can be very selective, resulting in superior risk-adjusted returns for investors. ICG was one of the first managers to launch a strategy focused exclusively on the asset class and raised in excess of $5bn for ICG Strategic Equity Fund IV, believed to be the largest dedicated pool of capital focused on investing in GP-led transactions.

