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| BRENT COUNCIL | **Pension Fund Sub Committee**<br>28th September 2010<br><br>**Report from the Director of Finance and Corporate Resources** |
| For Action | Wards Affected:<br>ALL |
| **Report Title:** | **Private Equity Investment – Revised proposals from Capital Dynamics** |

## 1. SUMMARY

The report proposes a revised private equity programme with Capital Dynamics.

## 2. RECOMMENDATIONS

Members are asked to agree:-

a) A revised investment programme and
b) To invest in a clean technology fund (the Solar Fund).

## 3 DETAIL

### Background

3.1 Private equity involves investing in companies that are not quoted on any stock exchange. The companies may be businesses that have been purchased by a private equity group to take private for restructuring, or family / partnership businesses that are in private hands. Reasons for investing in private equity have included diversification, a good income stream as businesses mature and are sold, and additional returns – private equity has returned 5% / 10% above public equity markets over the long term. Successful private equity managers have been able to demonstrate a ‘skill premium’ through the use of leverage (borrowing to fund investments), restructuring and efficiency savings.

3.2 Particular aspects of private equity include:-

a) A requirement to maintain investment over all periods, because good or bad years (vintages) cannot always be forecast.
b) Investments lose value over the initial four / five years (unless there are specific factors, as in secondary funds) as a result of restructuring costs and management fees. This process is known as the J curve.

c) A steady return of cash as the investments mature and are sold. This leads to investors 'overcommitting' to funds (committing more money to a fund than they actually want to invest), so that they actually reach their target exposure. Before 2005, Brent 'overcommitted' by 50%, but this rose in the boom years 2005 – 07 to around 70% before declining back to 50%.
d) Slow investment. The private equity investment period tends to continue over around five years. Although fund of funds have managers with whom they have long term relationships and access, the marketing of new funds and investment in underlying companies (with follow-up investments) takes some years.

**Brent Fund approach to private equity**

3.3 In 2002, Brent committed £5m to the Capital Fund for London, a regional venture capital fund managed by Yorkshire Fund Managers and underwritten by the Department of Trade and Industry (DTI) for up to £10m losses. To date, Brent has invested £2.75m in the Capital Fund, which remain deep in the 'J curve' reflecting the nature of venture capital and the recent recession. The manager has completed the initial investment phase, and will now only make follow-up investments with companies that show good prospects. In the last set of accounts (to 31st December 2009), the Brent Fund showed a loss of £0.5m on our investment, but the Fund has four years to run and should recover as investments mature.

3.4 In 2003, Brent appointed Westport Private Equity (later taken over by Capital Dynamics) to establish funds that would invest with other pension funds in a diversified approach across markets, managers and types of private equity. In 2005, members agreed to increase exposure to private equity from 3% of the Fund to 8%, and in 2007 a revised programme was established to invest in:-

a) USA, European and Asian markets, introducing new funds every three or so years to maintain continuous exposure.
b) Secondary Funds that invest in more mature private equity opportunities purchased from other investors. Initially CD was given the flexibility to invest in secondaries within each fund, but it became apparent that it was more effective to construct a specific fund that mainly targets smaller deals that are less competitively priced.
c) A Co-Investment Fund that invests alongside other investors.

**Current Issues**

3.5 Members will be aware of the current problems in private equity – the sharp falls in public equity markets in 2007 – 09 caused falls (less sharp, but still around 25%) in private equity valuations. It appears that private equity managers may have overpaid for assets in the period 2005/06. Since then, there have been few Initial Public Offerings (IPOs, the main route for private equity companies to go public), valuations have remained low because earnings multiples are low, and investment opportunities have reduced. It was apparent in 2008 and 2009 that the pace of investment had slowed sharply. It is also apparent that banks are less willing to lend to finance private equity purchases, so that funds will be required to invest more equity and probably reduce returns in future. However, as prices have fallen the investment background has improved so that valuations are now rising. Over longer periods, private equity has outperformed public equity markets by around 5% / 10% per annum. The Brent investment programme is as yet immature – many funds remain in the J curve – so that although the manager believes that prospects are good, results remain uncertain.

3.6 When the revised private equity programme was agreed in 2007, with a target exposure of 8% (to rise to 10% over the longer term), it was assumed that the overall Brent Fund would grow at an average rate of about 8% and that the surplus of income over benefits would accelerate growth even further. However, falling investment markets from 2007 – 2009 mean that the current investment programme may take private exposure to around 11% of the Fund in 2011/12. However, managers are usually slower at launching new funds and making new investments than they expect.

3.7 I have recently reviewed the programme with Capital Dynamics (CD). The manager is aware of the slow growth of the Brent Fund, and will scale back some future investment in new funds, but has raised the following:-

a) The programme should continue to gain exposure to all vintages and to diversify across markets. The manager believes that current prices mean that there are good opportunities to make excellent returns – CD targets 12.5% / 15% per annum. New European (2011), Emerging Markets (2011 and 2012) and USA (2012) funds are planned.
b) Exposure to emerging markets may be more appropriate than simply investing in Asia, where opportunities have been slow to appear.
c) The 2009 takeover of HRJ in the USA, a fund of fund private equity and property investment house, has given access to top-tier venture capital managers that were previously closed to CD. At present, Brent will gain exposure to these managers through the USA fund of funds (25% of investment), but Brent may wish to consider exposure to USA venture capital. This asset class has given good returns in USA, unlike UK, where the technology bubble destroyed value.
d) CD is launching a $300m clean technology fund at the end of September. The house has recruited an experienced team to take advantage of solar energy (commercial roof-top panels) opportunities in USA. The manager plans 10 – 15 investments in three or more USA states, and has already constructed a large pipeline of deals made more favourable by 30% tax allowances. It appears that the USA power generation market works in a somewhat similar fashion to UK, with consumers being charged for the change to renewable energy. The energy generated may be bought by the property owner or fed into the grid. Producers are required to increase the share of energy produced from renewables year by year. CD believes that the J curve will be short, that capital will be returned quickly but that income will continue over the long term.

3.8 It is suggested that the Brent Fund commits £10m ($15m) to the Solar Fund. Although fees are in line with other funds (1.75% plus 15% of profits above a return of 8% per annum), the opportunity appears to be good and CD have recruited an experienced team to manage the investment process.

3.9 The commitments to individual funds managed by Capital Dynamics will be:-

| | £m |
|---|---|
| European 2003 | 10.0 |
| USA 2003 | 6.5 |
| European Buyout 2005 | 15.0 |
| USA 2006 | 10.0 |
| European Co-Investments | 5.0 |
| European Mid Market 2008 | 20.0 |
| Generation VII USA | 15.0 |
| Asia | 5.0 |
| Global Secondaries | 20.0 |
| Clean Technology | 10.0 |

The Brent Fund will enter other new funds in Europe, USA and Asia as these are opened.

## 4. FINANCIAL IMPLICATIONS

4.1 These are included within the report..

## 5 DIVERSITY IMPLICATIONS

**5.1** The proposals in this report have been subject to screening and officers believe that there are no diversity implications arising from it.

## 6 STAFFING IMPLICATIONS

6.1 None

## 7 LEGAL IMPLICATIONS

7.1 There are no legal implications arising from the plans.

## 8 BACKGROUND

8.1 Pension Fund Sub Committee – 1st October 2007 - Private Equity – Proposals to increase exposure through Capital Dynamics - .

## 9. CONTACT OFFICERS

9.1 Persons wishing to discuss the above should contact the Exchequer and Investment Section, Brent Financial Services, on 020 8937 1472/74 at Brent Town Hall.

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